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FEDERAL INCOME ESTATE AND GIFT TAXATION

BY BORIS I. BITTKER

SOUTHMAYD PROFESSOR OF LAW
YALE UNIVERSITY

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To

the Memory of

WESLEY A. STURGES

Preface

This volume is the third edition of my *Federal Income, Estate and Gift Taxation*, published in 1955 as a revision and consolidation of earlier volumes, and revised in 1958. Because my pedagogical purposes have not changed, I take the liberty of repeating substantially what I said in the Preface to the 1955 volume.

* * * * *

As to Part I (Federal Income Taxation):

This part of the casebook was planned for a federal income tax course, preferably in the second year and after the student has had some work in corporations, trusts, and partnerships, of three or four semester hours. In that time, I believe that the bulk of the material can be adequately covered, at least if some portions are assigned for collateral reading without class discussion, though some sections (*e.g.*, corporate liquidations and reorganizations, non-family partnership problems, and accounting) might be reserved for more intensive study in an advanced course or seminar. If less time is to be devoted to federal income taxation, more drastic surgery would be called for, and I would be uncertain of the outcome. No doubt, a good deal of useful information can be passed along in a two hour course or the equivalent, or even in less time, but it would certainly be an unusual student who would gain, so rapidly, a proper appreciation of the pervasive effect of income tax on the rest of our law.

I do not mean to suggest that my intended audience is the prospective tax "expert." Quite the contrary. I have tried to address myself to the student who has no premature vocational interest in taxation, because federal income taxation today has the same credentials for a place in the law school curriculum as sales or trade regulation or trusts: it is an essential part of the well-educated lawyer's professional background, whether he ultimately makes vocational use of it or not.

I have tried to avoid burying the student in minutiae (with which the Internal Revenue Code is always overstocked), and this book is not a reference work, but the subjects covered are dealt with in some detail, because a "survey" would convey nothing of the spirit of income tax law. I have had to omit many subjects that would reward study, in order to concentrate on those fundamental problems (*e.g.*, income-splitting, capital gains and losses, business expenses as contrasted with capital outlays and personal expenses, the characteristics of income, the concept of annual accounting, etc.) that every student should grapple with.

With a "comprehensive revision" of the Internal Revenue Code* before us, the instructor may be tempted to close the books and study only the new statute. But pre-1954 law continues to be of great importance under the new Code. For while there is much in the law of federal income taxation that is "evanescent" (Coughlin v. Commissioner, infra, page 258), there is also much that is, if not permanent, at least tenacious. It is noteworthy that even in the "comprehensive revision" of

* So the Senate Finance Committee described the 1954 Code. S. Rept. No. 1622, 83d Cong., 2d Sess. 1 (1954).

1954, Congress drew back from proposals to alter the fundamental nature of the law at important points.*

Many provisions of the 1939 Code were re-enacted in haec verba or with only very minor changes. In some circumstances, the old law continues to govern in general, with restricted modifications for some taxpayers — for example, the expenses of child care are still non-deductible as a rule, though a limited class of taxpayers may deduct them to a degree. In some areas (*e.g.*, much of the partnership and short-term trust material), the new Code codifies a good deal of case law and administrative regulations. Other areas have been drastically altered, but we almost never start with a clean slate. Even the hotly debated credit for dividends received by individuals merely alters, without overturning, familiar comparisons between the corporation and the partnership or individual proprietorship as alternative means of carrying on the closely-held or one-man enterprise. Much old law will continue to be relevant in litigated cases for many years, and some will affect future transactions because, for example, it governs the basis of property acquired before 1954 or the calculation of corporate earnings and profits. At still other points, old cases, though overruled by the new Code, are excellent springboards for class discussion; and others, like Commissioner v. Court Holding Co. (infra, page 675) and Bazley v. Commissioner (infra, page 699), generated principles that will govern in foreign territory even though largely displaced in the area of their birth by the new statute. In my opinion, the study of pre-1954 statutes, cases, and regulations in conjunction with the 1954 Code is not just a temporary expedient. It is, rather, essential to an understanding of the new statute and, moreover, it offers an unusual pedagogical opportunity to inspire the student to examine the new statute, as statutes should be examined, relentlessly.

* * * * *

As to Part II (Federal Estate and Gift Taxation):

This subject has become of increasing importance to the practicing lawyer. But even those addicted to the theory that there is a corpus of law to which every law student must be exposed would probably not say that a curriculum is fatally defective because it slights estate and gift taxation. The subject's claim for attention rather rests, in the author's opinion, in its power to stimulate and

* In the field of corporate distributions and adjustments, for example, the House version of the 1954 Code made drastic changes that the Senate Finance Committee successfully opposed: "The House bill in this area is, in substance, an entirely new statute, using few of the terms or concepts with which the courts or the bar have become familiar over the years. Your committee has sought a less extreme approach. Rather than to replace the existing statute, it has sought to revise it so as to preserve the terms and concepts of existing law wherever possible. . . . The House bill departs from existing law by introducing the new terms, 'participating stock' (corresponding in general to common stock) and 'nonparticipating stock' (corresponding in general to preferred stock). It not only defines these terms but also contains a definition of the term 'security.' . . . Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments. Accordingly, your committee has returned to the use of the terms 'stock,' 'common stock,' 'securities,' etc., and, as in the case under existing law, has not attempted to define them in the statute." Id. at 42.

Commenting on the 1954 Code in J. C. Penney Co. v. Commissioner, 312 F.2d 65 (2d Cir. 1962), Judge Friendly said:

"The Internal Revenue Code of 1954 was the culmination of a long history; the Chairman of the Ways and Means Committee said in introducing it, "This bill represents a complete overhaul of all our revenue laws, the first since the enactment of the income tax." 100 Cong. Rev. 3420 (March 17, 1954). Even when the words of the Code may seem clear, courts applying it must look to what had gone before, to what was left intact, to what was altered and why."

challenge the student. The interplay of legislative, administrative, and judicial action: the attempt to steer a course true to the statute's purpose through the ever-changing and involuted channels cut by reluctant taxpayers; the search for a better tax program — these offer a limitless opportunity to the instructor.

A word about the structure of this part of the book. The gift tax is mainly a backstop to the estate tax; without the one, the other could achieve neither its social function of checking the undue concentration of wealth nor its incidental fiscal function of raising revenue. Chapter 11 gathers together a brief collection of gift tax materials to give a bird's-eye view of the main outlines of this tax; then the student passes on, in Chapters 12-14, to consider the competing claims of the estate and gift taxes in specific situations. In these chapters, the impact of the estate tax on various property arrangements is examined and compared with the gift tax's claim on the same arrangements. The remaining chapters deal with the valuation of property; the estate tax exemptions and deductions; computation of the federal estate tax and the credits applicable to it; federal estate and gift tax procedure; and apportionment of the federal estate tax among those interested in the gross estate. . . .

Although the material in Part II can be adapted for use in a course on estate planning, the structure has not been oriented in that direction. This reflects the author's conviction that an estate plan that heavily stresses tax advantages, without giving at least as much attention to the law and practice of fiduciary administration, insurance, wills, and other relevant fields, is an inexcusable disservice to the client. And, despite a few notable exceptions, much of the writing on estate planning betrays a willingness to sacrifice everything else to a dramatic showing of tax savings, though to be sure there is usually a pious warning that an estate plan cannot be valued solely by the number of dollars that is diverted from the Treasury to the heirs. The exaltation of this kind of estate planning ought not to be fostered by law schools.

The author has another reason for not moving toward what at the moment may seem to be the frontier of the future. Estate and gift taxes are the instruments of an important social policy. The practicing attorney, unless he happens to be on a public payroll, can hardly help but regard these levies as burdens to be avoided, if it is legally possible to do so. But the student has the time and the independence to reflect on their appropriate status in our public policy. If he can do so later on, when the problems of clients press themselves on him, so much the better. In any event, he will be a better citizen, and probably a better lawyer as well, if he has looked at these taxes at least once in the role of a legislator who is formulating a tax program. He will hardly do this in a course where he is playing estate planner; in the more orthdox tax course, at least the conditions are more suitable for such deliberation.

* * * * *

In editing the cases, rulings and other materials that follow, I have freely omitted footnotes and renumbered those that were left. In general, the appropriate sections of the 1954 Code have been substituted for citations of the 1939 Code and the revenue acts that preceded it, and I have frequently inserted references to the current Treasury Regulations in place of older citations. In some instances, however, I have either retained or supplied a reference to the 1939 Code or to the pre-1954 Regulations. My aim in modernizing citations has been pedagogical convenience, rather than rigid adherence to a set of formal principles, and the practice is accordingly not entirely consistent. At the beginning of most sections of the book, I have commented briefly on the relation between the 1954

Code and the 1939 law, so that in reading the cases and other materials the student may weigh the importance of any changes in the statute. In this connection, the table of Parallel Statutory References (page xxiii), which converts 1939 Code references to the appropriate sections of the 1954 Code, should be helpful. There are frequent references to "S. Rept."; this is S. Rept. No. 1622, 83d Cong., 2d Sess., recommending the enactment of H.R. 8300, which became the Internal Revenue Code of 1954.

I am very grateful to the authors and publishers who have consented to my use of extracts from their copyrighted works. I am also deeply indebted to Anne S. Bittker, my wife, for editorial assistance, to a number of students who over the years have served as research or editorial assistants, and to countless other students who have knowingly or unknowingly aided and abetted in my education.

BORIS I. BITTKER

New Haven, Connecticut
June 23, 1964

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MISCELLANEOUS

FEDERAL INCOME, ESTATE AND GIFT TAXATION

PART I

Federal Income Taxation

Introduction

A Bird's Eye View of American Tax History

The Sixteenth Amendment, empowering Congress "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration," became effective on February 25, 1913. In the fiscal year 1913, the federal income tax on individuals and corporations produced $35 million of revenue, less than 5 per cent of total federal receipts, a modest amount when compared to the yield of about $320 million from the tariff. For the fiscal year 1962, however, the federal income tax produced $66.1 billion, about 72 per cent of total federal general revenue and more than 1½ times the total taxes collected by all state and local governments in the United States. For the year 1913, a married couple with two children paid a federal income tax of $10 on a net income of $5000, of $260 on a net income of $25,000, and of $25,010 on a net income of $500,000; for the year 1964, the tax bills for these incomes were $325, $5280, and $346,062.[1]

These facts are of great significance to the lawyer, as to other citizens. But of even more professional interest to him is the manner in which the federal income tax has come, during the last three decades, to affect every branch of the law. Leases, conveyances, and mortgages; wills, trusts, and deeds; employment contracts, collective bargaining agreements, and pension arrangements; corporate security issues, liquidations, and mergers — every one of these legal events is today permeated with, if not dominated by, tax problems. The traditional comparison of the partnership and the corporation as methods of carrying on business enterprise (limited liability, perpetual existence, etc.) is hopelessly inadequate if the federal income tax is disregarded; an alimony agreement that is drafted without one eye on the Internal Revenue Code will probably be badly drafted; and a sale of anything more valuable than a lame horse requires at least brief attention to the tax "angle." Taxes were once the exclusive province of accountants,[2] but today even the general practitioner of law must know his way around this area. Nor is it only the practitioner who is affected by the Internal Revenue Code. The legal scholar who seeks to understand the rise of the sale and lease-back method of financing industrial and commercial property, or the growth of the family-controlled charitable foundation, or the use of multiple corporations to conduct a single enterprise must give due weight to the federal income tax. In

[1] The figures for 1913 and 1964 are not precisely comparable, because of differences in exemptions, deductions, etc., but the direction and degree of change are indisputable.

[2] On the respective jurisdictions of the attorney and accountant, see infra pages 983-985.

its impact on our law for good or for ill, the federal income tax must be set down as one of the creative forces in legal history, like the invention of the trust, the corporation, or the doctrine of respondeat superior.

No other tax has had such an effect on the practice or structure of the law, at least not in our time. Many attorneys encounter the real property tax, which in 1962 produced more than $18.4 billion for local governments, only at real estate closings, where its importance is minor; they may be acquainted with sales, use, and gross receipts ($12 billion in 1962 for state governments) and with the federal taxes on alcohol and tobacco ($5.3 billion in 1962) only as consumers; and no one will impugn the lawyer's professional competence if he goes through his career in ignorance of the customs duties. The federal income tax is something else again; the lawyer might better be ignorant of the rule against perpetuities, the parol evidence rule, or the requisites of negotiability.

How has this come about?

Until the Civil War, customs receipts were the backbone of the federal tax system; the only other important source of federal income was the sale of public lands, except for a miscellany of excise taxes imposed when customs receipts declined and expenditures increased during the War of 1812 and repealed shortly thereafter. During the Civil War, customs receipts were once again unable to carry the load, and it became necessary for Congress to seek other sources of federal revenue. Among the "war taxes" that it levied was an income tax. The measure was amended several times; the 1864 version imposed a tax of 5 per cent on incomes from $600 to $5000, of 7½ per cent on income from $5000 to $10,000, and of 10 per cent on income above $10,000. The Confederacy also employed an income tax, whose rates were steeper than the Union's, but its yield was much lower.

After the Civil War, the federal income tax was repealed and customs receipts once again became the basic source of federal revenue; but they were never again to be the only source. Federal excises on tobacco and liquor together produced almost as much as, and sometimes even more than, the tariff during the years between the Civil War and World War I. Throughout the seventies and eighties, moreover, agrarian and labor groups called for reductions in the tariff and for a revival of the federal income tax. To Eastern business interests, on the other hand, the income tax meant "confiscation," "spoliation," and "communism," and throughout this period the Republican Party held the fort against its assaults. The task became harder as the Democratic Party gradually emerged from its handicap as the party of secession, and it finally became impossible when the Populist movement gained strength from the panic of 1893.

In 1894, during Cleveland's second administration, a federal income tax, based largely on the Civil War statute, was passed by Congress after a bitter struggle, a notable feature of which was the oratory of William Jennings Bryan. A tax of 2 per cent was imposed on individual income over $4000 and a flat 2 per cent tax was imposed on the income of business corporations. Congress thus went far beyond Cleveland's modest recommendation, in his 1893 message to Congress, of a "small tax upon incomes derived from certain corporate investments." The income tax was carried by Democratic and Populist votes, but it must be viewed primarily as a regional victory of the South and Middle West over the Northeast, part of the same sectional movement that produced the Interstate Commerce Act in 1887, the Sherman Antitrust Act in 1890, and the unsuccessful campaign for bi-metallism. It is worth noting, however, that the Populist effort to obtain a progressive tax on individual income was defeated, though the $4000 exemption introduced a measure of graduation.

The tax became law on August 28, 1894, to take effect as of January 1, 1895, and by January 29, 1895, the Supreme Court had agreed to hear Pollock v. Farmers' Loan & Trust Co. (and a companion case), in which the Circuit Court for the Southern District of New York had refused to grant an injunction in an action that attacked the tax as unconstitutional.[3] Immense public interest was aroused by the five days of argument before the Supreme Court, in which notable attorneys and orators were engaged on both sides. The *Pollock* action was a suit by a stockholder to enjoin his corporation from paying the tax, a legal form that has been much criticized and is seldom encountered today.[4] Consequently, the tax was defended not only by the Attorney General but also by counsel for the corporation.

One ground of attack was that the income tax was a "direct" tax, and that it was not apportioned among the several states in proportion to population, as required by Article I, Section 9, Clause 4 of the Constitution:

> No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

A "capitation" tax clearly meant a poll tax, and there was general agreement that a tax on real estate, the kind that produces the bulk of municipal revenue today, was also a "direct tax" as that term was used in the Constitution. But was the income tax a "direct" tax because it included rents received by the owner of real property, along with all other types of income? If an income tax on rents derived from real property was a "direct" tax, was the inclusion of income from personal property (i.e., bonds, stock, etc.) equally invalid? Finally, if the inclusion of rentals or dividends and interest made the tax "direct," were these provisions separable from the rest of the tax, or was the statute invalid in toto?

Whatever may have been the purpose of the constitutional requirement that direct taxes be apportioned among the several states in relation to their population,[5] it was jeopardized by the lack of a consensus on what, besides a poll tax and a tax on real property, was included in the term "direct tax." Chief Justice Fuller was surely mistaken when he said in the *Pollock* case (157 U.S. at 573) that "the distinction between direct and indirect taxation was well understood by the

[3] Without President Cleveland's approval. The tax was a rider to the Wilson tariff bill, and Cleveland opposed its imposition of a tariff on sugar and other commodities. But since a veto would have kept alive the McKinley tariff schedules, Cleveland allowed the act to become law without his approval.

[4] Infra page 934.

[5] In the *Pollock* case, Chief Justice Fuller explained the provision's purpose as follows: "Nothing can be clearer than that what the Constitution intended to guard against was the exercise by the general government of the power of directly taxing persons and property within any State through a majority made up from the other States." 157 U.S. at 582. Seligman, on the other hand, concluded that the restriction was concerned only with the slavery question and was intended to induce the slave states to accept representation in the House of Representatives based on the number of free persons in the state plus only three fifths of the slaves, by promising that direct taxes would be similarly apportioned. This link between representation and direct taxation is clearly seen in Article I, Section 2, Clause 3 of the Constitution: "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons . . . three fifths of all other Persons." In keeping with this relationship between the direct tax clause and the treatment of slaves, Article V provided that until 1808, no amendment to the Constitution could be made changing either the direct tax clause or the clause permitting free migration into the country of such persons as any existing state might permit. Seligman comments: "The direct-tax clause was inserted into the constitution simply and solely as a concession to slavery, and with the disappearance of slavery and the adoption of the fourteenth amendment the very reason of its existence passed away." Seligman, The Income Tax (1911) 559.

framers of the Constitution and those who adopted it." More descriptive of the prevailing uncertainty is this extract from Madison's Notes: "Mr. King asked what was the precise meaning of *direct* taxation. No one answered." [6]

The term "direct tax" had caused difficulty at the very outset of the Republic. In 1794, Congress levied a tax on carriages, after a debate in which Madison argued that the tax was a direct one, while Fisher Ames, drawing on Massachusetts experience, asserted that it was indirect. The Supreme Court, in a case in which ex-Secretary of the Treasury Hamilton participated in the argument, held that the tax was constitutional.[7] Mr. Justice Chase was "inclined to think" that the only taxes that were "direct" within the meaning of the Constitution were the poll tax and taxes on land. Expressing doubt that a tax on personal property was "direct," he found that it was not necessary to decide, because "a tax on expense is an indirect tax; and I think, an annual tax on a carriage for the conveyance of persons, is of that kind. . . ." (3 Dall. 171, 174, (1796.) Mr. Justice Paterson and Mr. Justice Iredell, who wrote separate opinions, were equally unable to suggest any examples of a direct tax except the poll tax and taxes on land.

So far as federal income taxation was concerned, the Supreme Court's most important foray into the morass before the *Pollock* case was Springer v. United States, 102 U.S. 586 (1880). In this case, the Court unanimously upheld the validity of the Civil War income tax, which embraced (13 Stat. 479):

> the annual gains, profits, and income of every person . . . whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation . . . or from any other source whatever.

Citing the *Hylton* case, and other cases in which it had held that taxes on the receipts of insurance companies, on state bank notes, and on inheritances were all indirect taxes, the Court held that the federal income tax was also indirect, saying (102 U.S. at 602):

> Our conclusions are, that *direct taxes,* within the meaning of the Constitution, are only capitation taxes, as expressed in that instrument, and taxes on real estate; and that the tax of which the plaintiff in error complains is within the category of an excise or duty.

Despite this history, the Supreme Court in the *Pollock* case, by a vote of six to two (one Justice not sitting), held that insofar as it taxed income from real estate, the 1894 federal income tax was unconstitutional:

> . . . [I]t is admitted that a tax on real estate is a direct tax. Unless, therefore, a tax upon rents or income issuing out of lands is intrinsically so different from a tax on the land itself that it belongs to a wholly different class of taxes, such taxes must be regarded as falling within the same category as a tax on real estate *eo nomine*. . . . An annual tax upon the annual value or annual user of real estate appears to us the same in substance as an annual tax on the real estate, which would be paid out of the rent or income. . . . If, by calling a tax indirect when it is essentially direct, the rule of protection could be frittered away, one of the great landmarks defining the boundary between the Nation and the States of which it is composed, would have disappeared, and with it one of the bulwarks of private rights and private property. [157 U.S. at 580, 581, 583.][8]

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[6] 5 Elliot, Debates on the Adoption of the Federal Constitution (1866) 451.

[7] Hylton v. United States, 3 Dall. 171 (1796).

[8] The Editor, as the incumbent of a professorship established in honor of Charles F. Southmayd, cannot resist noting that Southmayd was credited by Joseph H. Choate, who argued the *Pollock* case, with working out the theory that a tax on rent was necessarily a tax on the property from which the rent was derived, thus providing "the keystone of the whole argument, and, indeed, of the decision which overthrew the Act of Congress." Choate, Memorial of Charles F. Southmayd, in Hicks (ed.), Arguments and Addresses of Joseph Hedges Choate (1926) 139, 148. See, however, 26

The *Springer* case was distinguished because none of the income of the taxpayer there in question was derived from real estate, a factual distinction that was accurate but that probably would have come as a surprise to the *Springer* court.

In addition to holding that the inclusion of rents was unconstitutional, the Court in the *Pollock* case decided, all eight Justices agreeing, that the inclusion of municipal bond interest constituted "a tax on the power of the States and their instrumentalities to borrow money" and that it was unconstitutional as a violation of our federal system of government. This determination was not of fundamental importance, because an income tax exemption for interest from state and municipal bonds was entirely feasible (and, indeed, later income tax statutes have exempted such income). It might even have been possible to re-enact a federal income tax with an exemption for income derived from real property. But two other questions were left unanswered because the Court was equally divided, and so long as these questions were in doubt, re-enactment of an income tax law was hardly likely. The first was whether a tax on income from personal property was an improper direct tax. This was a fundamental issue, because if not only rents but also interest and dividends were entitled to an exemption, a federal income tax would have to be restricted to personal earnings and business profits. Secondly, the Court did not decide whether the granting of a minimum exemption of $4000 to individuals violated the uniformity clause of Article I, Section 8, Clause 1 of the Constitution: "[A]ll Duties, Imposts and Excises shall be uniform throughout the United States." This issue too was basic. A third question of great immediate importance was also left unanswered by an equally divided Court: whether the invalid provisions taxing income from real estate and municipal bond interest were separable from the rest of the statute or rendered it invalid in toto.

One week later, counsel for the appellants applied for a rehearing on the undecided questions, and the Attorney General in response suggested that the whole case be reargued. The Court set both applications for rehearing down for argument in May, 1895; this time all nine Justices were on the bench. In a second opinion (158 U.S. 601), the previous holding as to income from real estate was reaffirmed by a vote of five to four. The same five justices agreed that a tax on the income from personal property was an invalid direct tax, and they held that the invalid provisions were not separable from the rest of the tax, so that the tax was invalid in toto.[9] Mr. Justice Jackson, who did not sit on the first argument, voted to uphold the tax on all three counts. Since he was part of a minority of four, it was immediately assumed that one of the four Justices who at the first argument thought the tax on income from personal property was proper and that the provision taxing rents was separable from the rest of the statute must have switched sides. This in itself would not have been of earth-shaking importance, but it was dramatic evidence of the power of a single judge, and the fact that the reports did not reveal the name of the "vacillating" judge lent an air of mystery to the event. Mr. Justice Shiras was long identified, on what now seems to be

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Cong. Rec. 6826-6827 (1894), which shows that this argument was made during the debate preceding enactment of the 1894 tax and that an amendment to exempt rents from real estate on the ground that their inclusion would be unconstitutional was rejected.

[9] The Court did not find it necessary to pass on the other undecided question — did the $4000 exemption violate the uniformity clause of Article I? A few years later, however, in Knowlton v. Moore, 178 U.S. 1 (1900), the Supreme Court held that a federal inheritance tax was constitutional despite certain exemptions; the term "uniform throughout the United States," it held, meant geographical uniformity, so that persons and property would be taxed in the same manner without regard to geographical location, rather than "intrinsic" uniformity (i.e., without exemptions). See also Brushaber v. Union Pacific Rr. Co., 240 U.S. 1 (1916) (progressive rate structure not a violation of due process clause of Fifth Amendment).

slim evidence, as the judge who switched, though some scholars have more recently awarded the blame, or credit, to others. It is also possible that the assumption of a switch is incorrect.[10]

After the *Pollock* decision, advocates of the income tax turned to an amendment to the Constitution as a means of reviving the tax, though there was also some agitation for confronting the Supreme Court with a new statute in the hope of securing a reversal of the judicial position. McKinley's victories in 1896 and 1900 over William Jennings Bryan, the candidate of the Democrats and Populists, reflected the temper of the times, however, and not even the financial demands of the Spanish-American War could restore the federal income tax. But within a few more years after the *Pollock* case, in which Mr. Justice Field had called the income tax "usurpation," an "assault upon capital," and "the steppingstone to . . . a war of the poor against the rich" (157 U.S. at 607), the very same tax had found eminent support within the Republican Party itself: both Theodore Roosevelt and William Howard Taft announced that they favored a federal income tax. Taft, indeed, expressed at one time the view that a constitutional amendment might not be required because of the changed membership on the Supreme Court, though he later reconsidered. Bryan, apparently having more faith in the rule of precedent than the future Chief Justice, insisted that a constitutional amendment was necessary, and that Taft's hope of a change in the Supreme Court's sentiment was insincere. Whether Taft himself was engaged in a campaign maneuver or not, the insurgent Republicans who followed Roosevelt were unquestionably serious.

In 1909, a combination of these insurgent Republicans and the Democrats laid plans for an income tax amendment to the Payne-Aldrich Tariff bill, then pending in the Senate. The proposal was to tax both corporate and individual incomes, with a $5000 exemption; it was a direct challenge to the *Pollock* case, except that interest from state, county, and municipal bonds was to be excluded, in recognition of the Supreme Court's unanimity on this point. The conservative wing of the Republican Party was able to head off the threat by winning over President Taft, but the price of victory was high. To obtain Taft's assistance in beating down the income tax on individuals, its opponents were forced to agree to the enactment of a corporate income tax[11] and to a joint resolution proposing

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[10] There is a full account of the puzzle and a review of earlier comments in Shiras, Justice George Shiras, Jr. of Pittsburgh (1953) 168-183.

[11] The 1909 corporate income tax was held constitutional in Flint v. Stone Tracy Co., 220 U.S. 107 (1911). The Court rejected (220 U.S. at 150) the argument that it imposed an unapportioned "direct" tax:

"Within the category of indirect taxation, as we shall have further occasion to show, is embraced a tax upon business done in a corporate capacity, which is the subject-matter of the tax imposed in the act under consideration. The *Pollock* case construed the tax there levied as direct, because it was imposed upon property simply because of its ownership. In the present case the tax is not payable unless there be a carrying on or doing of business in the designated capacity, and this is made the occasion for the tax, measured by the standard prescribed. The difference between the acts is not merely nominal, but rests upon substantial differences between the mere ownership of property and the actual doing of business in a certain way."

The Court also upheld (220 U.S. at 162) the inclusion of income from state and municipal bonds:

"It is further contended that some of the corporations, notably insurance companies, have large investments in municipal bonds and other non-taxable securities, and in real estate and personal property not used in the business, that therefore the selection of the measure of the income from all sources is void, because it reaches property which is not the subject of taxation — upon the authority of the *Pollock* case, supra. But this argument confuses the measure of the tax upon the privilege, with direct taxation of the estate or thing taxed. In the *Pollock* case, as we have seen, the tax was held unconstitutional, because it was in effect a direct tax on the property solely because of its ownership."

a constitutional amendment to permit an individual income tax on all types of income. Taft favored the constitutional amendment partly as a sop to the insurgents and partly because he thought that an income tax might be good policy in time of great national need. The backers of the income tax were dismayed by Taft's open opposition and especially by the fact that a constitutional amendment could be defeated if only twelve state legislatures were won over by the conservatives.[12] Moreover, even with an amendment to the Constitution, the battle in Congress would have to be fought again, perhaps at a less auspicious time.

The joint resolution passed by Congress in 1909 on Taft's insistence, which in 1913 became the Sixteenth Amendment, was in the following terms:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The most influential opposition to the proposed amendment, when it was before the states for ratification, stemmed from a special message from Governor Charles Evans Hughes to the New York State Legislature in 1910. Governor Hughes stated that he believed the federal government should have the power to impose an unapportioned income tax, but he recommended against ratification because the words "from whatever source derived" in the proposed amendment, "if taken in their natural sense," would permit income from state and municipal bonds to be taxed by the federal government, a power that would "afford the opportunity for federal action in violation of the fundamental conditions of State authority." This message led to the defeat of ratification in New York in 1910. Some supporters of the amendment rejected Hughes' construction, but others were willing to accept it, and his views were quoted throughout the nation. But the Democrats and insurgent Republicans were successful in the state elections of 1910 and 1912, and by early in 1913 thirty-six states (including New York) had ratified the amendment.

The Sixteenth Amendment thus became a part of the Constitution on February 25, 1913, less than four years after the advocates of the income tax thought they had been defrauded of victory by the maneuver of the tax's opponents. Within a few months, moreover, Congress passed the Revenue Act of 1913, imposing a "normal" tax of 1 per cent (with an exemption of $3000 for an individual and of $1000 additional for a married person living with his spouse) and a "surtax" ranging from 1 per cent on net income from $20,000 to $50,000 up to 6 per cent on that part of any net income exceeding $500,000. This should be compared with the income tax proposal that was defeated in 1909: a flat 2 per cent on net income in excess of $5000.

The Role of the Income Tax Today: A Brief Survey

The income tax's career from 1913 to the present day is starkly summarized in Tables I and II.

Where do we go from here? In answering this question, we might begin by examining the last column of Table II — the expenditures of the federal government. These expenditures, broken down for several recent years, are shown in Table III.

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[12] Amending the Constitution seemed a graver and more formidable undertaking then than now; the first ten amendments were virtually part of the original Constitution, the eleventh and twelfth had been adopted in 1798 and 1804, and for more than a century the only other amendments were the thirteenth, fourteenth, and fifteenth, representing the political settlement of a civil war.

TABLE I

FEDERAL INCOME TAX* ON MARRIED COUPLE WITH TWO DEPENDENTS ON NET INCOME (BEFORE EXEMPTIONS) OF:

	$2,000	*$5,000*	*$10,000*	*$25,000*	*$100,000*	*$500,000*
1913		$ 10	$ 60	$ 260	$ 2,510	$ 25,010
1920		104	558	2,848	31,158	303,158
1930		8	83	994	15,739	115,739
1940		75	440	3,571	42,948	329,637
1945	$45	755	2,245	9,705	68,565	442,985
1950		452	1,417	5,672	47,208	369,645
1955		520	1,592	6,268	51,912	402,456
1960		520	1,592	6,268	51,912	402,456
1964		325	1,200	5,280	45,721	346,062
1965		290	1,114	4,944	43,140	318,600

* Assuming use of standard deduction and no capital gains or other specially treated items.

What are the prospects for a massive reduction in these expenditures — not by substituting paper napkins for linen on naval flagships, but by fundamental cuts in the budget? Much of our budget obviously hinges on the men in Moscow and Peiping, not on Bostonians and San Franciscans. A dependable international settlement would have a prompt repercussion on federal expenditures, and so would further aggression. Our expenditures for national defense and foreign aid reflect our international hopes, aims, and estimates. These in turn are partly trimmed to our economic position, but not even those who believe that the Kremlin's long-range strategy is to lure us into "bankruptcy" would recommend a cessation of defense expenditures to improve the national financial statement. Other important items in the federal budget, like veterans' benefits and interest on the public debt, can be reduced only painfully. The prospect for a substantial

TABLE II

FEDERAL RECEIPTS AND EXPENDITURES AND GROSS NATIONAL PRODUCT

(In Millions of Dollars)

	Receipts from: *Individual income tax*	*Corporate income tax*	*All sources*	*Expenditures*	*Gross National Product*
1913	35*		724	725	
1920	3,957*		6,695	6,403	
1930	1,147	1,263	4,178	3,440	91,105
1940	982	1,148	5,144	9,062	100,618
1945	19,034	16,027	39,771	60,448	213,558
1950	17,153	10,854	37,045	40,167	284,559
1955	31,652	18,265	60,390	64,570	397,469
1960	40,715	21,494	77,763	76,539	503,443
1964**	47,500	23,700	88,400	98,400	623,000
1965**	48,500	25,800	93,000	97,900	

* Sum of individual and corporate income taxes; separate figures not available.
** Estimates

Source: Statistical Abstract of the United States (1957, 1963); President's message to Congress (Jan. 21, 1964).

TABLE III

FEDERAL ADMINISTRATIVE BUDGET EXPENDITURES

(In Billions)

	1957	*1961*	*1965*•
National defense	$43.4	$47.5	$54.0
International affairs and finance	2.0	2.5	2.2
Space research and technology	0.8	0.7	5.0
Agriculture and agricultural resources	4.5	5.2	4.9
Natural resources	1.3	2.0	2.6
Commerce and transportation	1.3	2.6	3.1
Housing and community development	– 0.1	0.3	– 0.3
Health, labor, and welfare	2.6	4.2	6.0
Education	0.4	0.9	1.7
Veterans' benefits and services	4.9	5.4	5.1
Interest	7.3	9.0	11.1
General government	1.7	1.7	2.2
Miscellaneous (including interfund transactions)	– 0.5	– 0.7	0.2
Totals	$69.0	$82.0	$97.9

• Estimates.

Source: Statistical Abstract of the United States (1963), Table 516; President's Budget Message, 1964.

cut in these expenditures is dark. Still other domestic expenditures are more flexible, but social aims, regional and occupational pressures, political pledges and ambitions, and kindred drives may lead to increases instead of to reductions. Moreover, if expenditures that aid one group (farmers, veterans, tenants of public housing developments, etc.) are — or seem to be — financed by taxes on other groups, the pressure to cut expenditures may be decisively overbalanced by the drive to increase benefits. Last year's level of federal expenditures is not sacrosanct; one has only to examine the last column of Table II to see how widely expenditures can vary from decade to decade. But Table III also demonstrates that our international interests, aspirations, and responsibilities are of overwhelming importance in fixing the level of national expenditures.

So much for the expenditure side of the federal budget. What of federal taxes? While the two items are related, they are certainly not in balance. Though expenditures decline, the level of taxation may be maintained to produce a surplus for debt retirement, to combat inflation by draining off funds that might be used for consumer goods, or for other reasons. Conversely, taxes might be cut without a corresponding decline in expenditures, the gap being closed by government borrowing. Such a fiscal policy might be adopted in a depression in order to stimulate the national economy by government spending; deficit financing may also be resorted to in wartime, to finance expenditures essential to national survival, if taxes are already as high as is politically or economically feasible. A gap between federal expenditures and federal taxes, then, is not only possible but may be a deliberately adopted policy. Still, one cannot minimize the facts that, on the one hand, there is strong opposition to deficit financing, while, on the other hand, any decrease in federal expenditures will stimulate a demand that the "saving" be "passed on" to the taxpayer. The bond between taxes and expenditures cannot be ignored, then, though it may be more of an uneasy family tie than an inflexible chain. Without a drastic change in federal expenditures, a drastic change in total federal taxes is unlikely.

To be sure, the taxpayer's readiness to accept heavy federal expenditures will

be molded not only by his assessment of their short and long run value to him, but also by the type of tax imposed to finance the expenditures. A tax that is out in the open, like an income or sales tax, may cause more resistance to federal expenditures than one that is less clearly identifiable — like a manufacturer's excise, though even the latter type of tax, if separately stated by the vendor of products or services, may produce "tax consciousness" on the consumer's part. An income tax paid once a year may be a crushing blow, while the same amount withheld from wages may not be missed, as though gross wages were a mirage and "take-home" pay the only reality. On the other hand, if the tax is hidden, some taxpayers may be uneasy about expenditures they would endorse if they knew where the money was coming from; and still others, feeling that the income tax withholding system is fit only for serfs and school children, may protest any expenditures by a government that will not trust them until the annual due date. The distribution of the burden among economic and regional groups and the taxpayer's sense of justice also affect the likelihood of a taxpayers' movement for the reduction of expenditures. While a taxpayers' revolution is always possible, the author's own, no doubt unforgivably cynical, conclusion is that the users of the mail are about as likely to band together to force a reform of the postal service.

If federal expenditures, and hence federal taxes, remain high, what part will the federal income tax play in the foreseeable future? Its phenomenal success in raising revenue cannot be disputed, but its position of pre-eminence has not gone unchallenged. Some critics argue that it is dangerous for the federal government to rely so heavily on a tax whose yield is entirely at the mercy of national income, so that any decline in income will produce an immediate decline in revenue.[13] To others, however, this "built-in flexibility," far from being a drawback, is one of the merits of the income tax; the automatic decline in tax liability when income falls serves to release consumer spending power when it is most needed, without the delay of political action, while in a period of boom, the automatic rise in tax liability serves to reduce the inflationary pressure of increased purchasing power.

The most vigorous attacks on the pre-eminence of the federal income tax, however, have come from those who fear its strength, not its instability. In part, the fear is that the income tax undermines the incentive to work. The criticism is not easily assessed, and the task is not made less perplexing by the fact that many of the critics are academic economists, who, if they are themselves motivated by financial ambition, have shown poor judgment, and lawyers, among whom the tradition of uncompensated public service is strong. Some taxpayers are indifferent to money; but others, no doubt, are indifferent to everything else. Even those who do not themselves care much for money may of course be goaded into lethargy by the government's demands for part of what they earn. Of those taxpayers who are driven principally by ambition for financial success, some may work harder under the lash of the income tax to maintain a stable after-tax income, while others may flee to Florida or Tahiti or to jobs that require less energy. While in general it is thought that an income tax on wages and salaries cannot be shifted by the taxpayer, it may be that some groups, e.g., organized labor, may demand higher pay for the same work, leaving their incentives untouched by the tax, except insofar as the whole economy eventually reflects the higher cost of labor. The income tax's impact on incentives is unquestionably also affected by the purpose for which the tax is levied, the climate of political opinion, the steep-

[13] For estimates of the effect of a reduction in personal income on the yield of the federal income tax on individuals, see Pechman, Yield of the Individual Income Tax During a Depression, 7 Nat. Tax J. 1 (1954). See also Poole, Rolph, Brown, and Lutz, 3 Tax Revision Compendium, House Committee on Ways and Means (1959) 2331-2382.

ness of any increase, the prospects for later changes in tax rates, the taxpayer's sense of justice, etc.

If we assume that the federal income tax impairs the incentives of persons who can join or withdraw from the labor market with comparative freedom — like men near retirement age or housewives — one must still decide whether it is undesirable for housewives to turn down factory jobs or for business executives to accelerate their retirement. Opinions would surely differ, and we cannot avoid the question by saying that such decisions should be left to the individual without coercion by the tax system. All taxes have effects on the economy, and if the income tax were reduced or repealed to encourage the housewife or older executive to work, some other tax would have to be imposed, or deficit financing would have to be resorted to, and the taxpayer would then be coerced in some other area of his economic life. We know little of the incentive effects of income taxation,[14] but even if we knew much more, policy decisions would not flow inexorably from the information.

Economists seem to feel on more solid ground when they turn from the impact of income taxation on incentives to its effect on consumption and savings. Assuming that the tax is not shifted, as by a successful demand for higher wages or salaries, the usual view is that it deprives low income taxpayers of funds that would go for consumer goods and services, while high income groups are impelled to reduce their savings rather than their consumption. This conclusion rests on the assumption that low incomes are largely or entirely exhausted by consumption expenditures, saving being either nil or confined to relatively inelastic items like insurance premiums. Higher income groups devote increasingly large portions of their income to savings, it is thought, and hold their consumption at relatively inflexible levels. Our knowledge of the distribution of investments among income groups is fragmentary, but one careful study presented these conclusions:

> 1. That, as a minimum estimate, the top 1 per cent of all spending units with incomes of about $15,000 and over accounted for more than one quarter of the annual accumulations of investable funds made by all spending units in 1948 and presumably also in other postwar years.
>
> 2. That, again as a minimum estimate, the top 3 per cent of all spending units with incomes of $10,000 and over accounted for more than 40 per cent of the total.
>
> 3. That the top 5 per cent of all spending units with net incomes of $7500 and over accounted for more than 55 per cent of the total.[15]

These estimates of 25 per cent, 40 per cent, and 55 per cent as the annual accumulations of investable funds by the top 1 per cent, 3 per cent, and 5 per cent were regarded by the authors as minimums that might more probably be stated as 30-35 per cent, 45-50 per cent, and 60-65 per cent respectively.

Though these statistics indicate a high degree of concentration of "investable funds," they also indicate that some 65-75 per cent of the annual accumulation of such funds is diffused among the 99 per cent of spending units with incomes of under $15,000.[16] The income tax even at present rates is hardly confiscatory

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[14] A study of business executives found some evidence of an adverse effect of income taxation on incentives, but it also states: "The evidence of the interviews tends to show that the extent to which business executives have reduced their work and effort, as a result of taxes, has frequently been much exaggerated . . . What all history goes to show is again confirmed by a good deal of evidence in this study, that difficulty, danger, and strenuous effort are themselves incentives to many men." Sanders, Effects of Taxation on Executives (1951) 12, 14. See also Break, Income Tax Rates and Incentives to Work and to Invest, 3 Tax Revision Compendium, House Committee on Ways and Means (1959) 2247.

[15] Butters, Thompson, and Bollinger, Effects of Taxation: Investments by Individuals (1953) 19.

[16] Another study estimates that of the $12 billion of corporate dividends attributable to individuals in 1960, 27.2 per cent was received by persons with adjusted gross income under $10,000,

at the level of $15,000 and below, and these are the families that would have to bear the brunt of any alternative tax that might be levied to replace the federal income tax. Would their investment capacity be enhanced, or reduced, if Congress turned its affections from the income tax to a national sales or manufacturers' excise tax? One must not overlook, of course, the apparent fact that the higher income groups, on whom the income tax rests more heavily, invest increasingly higher portions of their investable funds in risk ventures, without which there can be no sound investment of lower class money; and it is also possible that lower income groups keep disproportionately large parts of their savings in the form of cash rather than in investments. But we may be seeing a shift in this pattern, as insurance companies, pension funds, investment companies, and other pools of capital that are fed by lower income groups exhibit an interest in the type of business equities that they once avoided as imprudent investments. Moreover, installment investment plans for lower income groups may introduce an element of inelasticity here, at least so long as wages exceed the subsistence level. It is not inconceivable that we will become a nation of mass investment, as well as mass purchasing, power. If that time is already at hand, we shall have to rethink, and perhaps to revise, our views of the relation of income taxation to savings and investment.

Individuals are not the only source of funds for investment, of course, and they may not even be the most important. Corporate investment in recent years has been financed by retained earnings more than by the sale of securities. The corporate income tax reduces earnings available for investment, though this pressure may be alleviated to some unknown degree by a shifting of the tax through the medium of higher prices or lower wages. It may also be alleviated by a reduction in dividends, though this expedient, while conserving the corporation's internal resources, would repel outside capital. Besides reducing the supply of corporate capital for investment, an income tax may reduce the incentive to invest. Generalizations in this area are but faint guideposts to national policy, however, without differentiation according to the size, age, and risk of the enterprise. In its present form, the federal income tax may encourage investment in bonds rather than in stocks, and in tax-exempt state and municipal bonds rather than in taxable securities, but these effects, which will be adverted to later in this book, are more adventitious than central to income taxation.

As has already been indicated, the attempt to measure or predict the effect of income taxation on the drive to work and on the pattern of consumption, savings, and investment, is complicated by the rudimentary state of our knowledge about the incidence of taxation. Does the burden of an income tax rest on the person who pays it, or can he shift the burden, in either the short or the long run, to others? Traditionally it has been thought that an income tax on business profits cannot be shifted either by cutting wages or other costs or by raising prices, because the taxpaying business must compete with the marginal firm that, because it is just breaking even, pays no income tax, and fixes its own (and therefore its competitors') prices without regard to the tax. In recent years, however, economists have been less sure that the marginal firm sets the pace for the others; and, even if it theoretically would do so under conditions of perfect competition, the intervention of monopolistic advantages (trade names, unique locations, other forms of goodwill, etc.) will in practice greatly modify the role of the marginal producer. It may be that even with such advantages, the most profitable

and another 26 per cent by those with adjusted gross income from $10,000 to $25,000, with a total of 70 per cent being received by persons with adjusted gross income under $50,000. Crockett and Friend, Characteristics of Stock Ownership (U. of Pa. 1963, preliminary) Table 1.3. See also Holland, Dividends Under the Income Tax (1962) Table 2.

price prior to the levy of an income tax will still be the most profitable price afterwards, so that the tax could be the occasion but not the cause of increased prices. But if the firm has not previously pressed its advantages home and is impelled to do so by the tax, the tax has in a very real sense been "shifted." The chairman of the finance committee of the U.S. Steel Corporation and the research department of the C.I.O. have both asserted that corporate income taxes are costs that are passed on to the public in the form of higher prices,[17] and one must think twice before rejecting these empirical opinions in favor of a contrary position that is derived from an economic "model" that may have no counterpart in real life. An income tax that was shifted would, of course, have very different effects upon incentives, savings, and investment from one whose burden remained on the taxpayer.

Many economists who reject the possibility of a short-run shifting of an income tax acknowledge that it may be shifted in the long run. If the marginal firm is earning no profits, they reason that it will be induced to transfer its investment to a sector of the economy where a return can be realized, thus curtailing supply in the old area, while no new funds will flow there until prices have risen sufficiently to offer a profit. These effects can be felt only as fast as the marginal firms can, and will, liquidate. Similarly, the traditional view has been that an income tax on wages cannot be shifted. But a strong union's insistence on stable "take-home" pay will surely have some effect, at least in the short run. When we look beyond the immediate consequences of such institutional pressure, however, we find that increased wages will in turn affect prices, consumption, and investment, and predictions become precarious indeed.

The principle of progression in the federal income tax has always been controversial, but since the end of World War II it has been more severely criticized than at any time since the formative years of the tax. Just as many supporters of the tax look on progression as its greatest virtue (though they may disagree about the proper rate of progression), so many of its critics have come to think that this is its worst characteristic; and, unquestionably, a proportional income tax would be palatable, and perhaps even attractive, to some of them. Progression is inescapable if any personal or dependency exemptions are allowed, a practice as old as the British income tax of 1799, and a more deliberate form of progression also has some eighteenth and early nineteenth century antecedents.[18] But not until the Civil War income tax (both in the North and the South) can significant graduation be found, and this was only the primitive origin of what is now, as Table I indicates, a fine art. As the student will soon discover, many of the most troublesome administrative and legal problems created by the federal income tax are the direct result of progression; these difficulties and complications may not in themselves count heavily against progression, if it can be defended on more fundamental grounds, but they do force us to think about whether a progressive tax has advantages over a proportional tax that would be much simpler.

Is progression justified? The taxes on cigarettes, whiskey, retail sales, and real property are the same for each taxable item and taxpayer. If the taxpayer's pur-

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[17] Goode, The Corporation Income Tax (1951) 44-45.

[18] In rejecting a contention that the progressive rate structure of the 1913 income tax violated the due process clause of the Fifth Amendment, the Supreme Court said in Brushaber v. Union Pacific Railroad Co., 240 U.S. 1, 25 (1916): "It is true that it is elaborately insisted that although there be no express constitutional provision prohibiting it, the progressive feature of the tax causes it to transcend the conception of all taxation and to be a mere arbitrary abuse of power which must be treated as wanting in due process. But the proposition disregards the fact that in the very early history of the government a progressive tax was imposed by Congress, and that such authority was exerted in some, if not all, of the various income taxes enacted prior to 1894 to which we have previously adverted."

chases increase in number or his property in value, he pays proportionately, not progressively, more. If the tax on the third martini is no more than the tax on the first, why should the millionth dollar of income in a given year be taxed more heavily than the ten-thousandth? A number of arguments for progression have been put forward; some are variations on the "sacrifice" theory, assuming that it is less painful to relinquish the last dollar of a high income than the last dollar of a lower income, an idea that is popularly expressed in the phrase, "ability to pay"; some rest on the assumption that the benefits "bought" with taxes increase progressively with the taxpayer's income or wealth; sometimes there are appeals to equalitarian principles; and sometimes it is argued that progression contributes to a better balance between savings and consumption in the economy. None of the purely "rational" arguments is entirely satisfactory; either they rest on premises that are intuitive rather than demonstrable, or they carry implications that go far beyond progressive taxation alone. It seems likely that the emotional and ethical appeal of progression is ultimately more compelling; but, of course, it is less susceptible to analysis. The authors of a painstaking examination of the intellectual history of progression concluded:

> The case for progression, after a long critical look, thus turns out to be stubborn but uneasy. The most distinctive and technical arguments advanced in its behalf are the weakest. It is hard to gain much comfort from the special arguments, however intricate their formulations, constructed on notions of benefit, sacrifice, ability to pay, or economic stability. The case has stronger appeal when progressive taxation is viewed as a means of reducing economic inequalities. But the case for more economic equality, when examined directly, is itself perplexing. And the perplexity is greatly magnified for those who in the quest for greater equality are unwilling to argue for radical changes in the fundamental institutions of the society. [Blum and Kalven, The Uneasy Case for Progressive Taxation (1953) 103, also to be found in 19 U. of Chi. L. Rev. 417 (1952).]

The strength of conviction in this area is amply demonstrated by reviews of the Blum-Kalven study. John Chamberlain, in whose eyes the Sixteenth Amendment "legalizes a theft," welcomed the book for conferring "academic recognition" on "the intellectual sapping operation against the progressive principle." [19] Randolph Paul, on the other hand, asserted that the book "has confirmed rather than shaken my belief that there should be more, rather than less, progression in the American tax system." [20]

In point of fact, although the maximum rate of the 1954 Code soared to 91 per cent (taxable income in excess of $300,000 on a separate return, $400,000 on a joint return), and was not reduced to its present level of 70 per cent until 1964, marginal rates, of course, apply only to that part of taxable income that exceeds the previous bracket, so that the average or effective rate is always lower than the marginal rate. Moreover, the degree of progression is reduced even more by the omission of such items as state and municipal bond interest from the taxable base, by the reduced rate applicable to long-term capital gains, and by such deductions as percentage depletion. Thus, Table IV shows that the effective tax rate for taxable returns filed for 1960 was below 35 per cent of "amended adjusted gross income" (roughly speaking, gross income less business deductions, but including capital gains in full) for taxpayers with $100,000 to $200,000 of amended adjusted gross income and even lower for those in the $1,000,000 and over bracket. If "amended adjusted gross income," as employed in Table IV, were recomputed to take account of tax-exempt state and municipal bond interest, deductions for percentage depletion to the extent they exceed the taxpayer's actual investment, and certain other items that are excluded or deducted in computing taxable in-

19 Book review, 21 U. of Chi. L. Rev. 502, 503, 505 (1954).
20 Book review, 67 Harv. L. Rev. 725, 730 (1954).

come though they do not reduce the taxpayer's spendable income, the effective rates would probably be even less progressive.

TABLE IV

EFFECTIVE TAX RATES BASED ON ADJUSTED GROSS INCOME AND AMENDED ADJUSTED GROSS INCOME FOR ALL TAXABLE RETURNS, 1960

(Dollar Amounts In Millions)

Adjusted gross income	*Number of returns (thousands)*	*Adjusted gross income*	*Excluded net long-term capital gains*	*Amended adjusted gross income*	*Tax after credits*	*Tax as percent of adjusted gross income*	*Tax as percent of amended adjusted gross income*
Up to $5,000	22,751.0	$69,141	$423	$69,564	$6,274	9.1	9.0
$5,000-$10,000	19,998.0	138,455	789	139,244	15,362	11.1	11.0
$10,000-$20,000	4,422.0	56,128	933	57,060	8,448	15.0	14.8
$20,000-$50,000	764.0	21,901	1,001	22,902	4,993	22.8	21.8
$50,000-$100,000	101.0	6,648	652	7,300	2,273	34.2	31.1
$100,000-$150,000	14.0	1,688	283	1,971	681	40.3	34.6
$150,000-$200,000	4.0	750	170	920	320	42.6	34.7
$200,000-$500,000	5.0	1,370	451	1,821	607	44.3	33.3
$500,000-$1,000,000	.7	486	240	726	226	46.4	31.1
$1,000,000 and over	.3	584	285	869	281	47.8	32.3
Total	48,061.0	297,151	5,226	302,377	39,464	13.3	13.0

Source: 1960 Statistics of Income.
From: Hearings on Revenue Act of 1963 (H.R. 8363), Senate Finance Committee, 88th Cong., 1st Sess. (1963), Part 1, p. 278.

If we widen our angle of vision to embrace other types of taxes in judging the degree of progression in the total tax burden — national, state, and local — we encounter much that is obscure, but it is at least possible that the progressivity of the federal income tax merely counteracts the regressivity of state, local, and other federal taxes, producing an aggregate national tax burden that is roughly proportionate to income.[21] However progressive, regressive, or proportionate a tax (or the entire tax burden) may be as to income classes, however, the taxpayers in any one class may well bear unequal burdens. The effective rates of Table IV, for example, are averages for the income classes in question, and the effective rate for any individual taxpayer may be very different from the average for his income class because of differences in the "mix" of income items received. Thus, for 1002

[21] See Musgrave, How Progressive Is the Income Tax? 3 Tax Revision Compendium, House Ways and Means Committee, 1959, p. 2223; Bishop, The Tax Burden by Income Class, 1958, 14 Nat. Tax J. 41 (1961); Musgrave, Carroll, Cook, and Frane, Distribution of Tax Payments by Income Groups: A Case Study for 1948, 4 id. 1 (1951); Tucker, Distribution of Tax Burdens in 1948, 4 id. 269 (1951); Musgrave and Frane, A Rejoinder to Dr. Tucker, 5 id. 15 (1952); Colm and Wald, Some Comments on Tax Burden Comparisons, 5 id. 1 (1952); Neisser, The Dynamics of Tax Burden Comparisons, 5 id. 351 (1952). These articles cite several earlier studies.

For another conclusion ("the total tax system is highly progressive in its effect"), see Beaton, Family Tax Burdens by Income Levels, 15 Nat. Tax J. 14 (1962); see also Tax Foundation, Allocation of the Tax Burden by Income Class (1960).

For an attempt to gauge the net redistributive effect of the American fiscal system, taking into account not only tax burdens but also the receipt of benefits by income groups, see Adler, The Fiscal System, the Distribution of Income, and Public Welfare, in Poole, Fiscal Policies and the American Economy (1951) 359.

For a discussion of the theoretical framework of progression, see Morag, Reflections on Progressive Taxation, 11 Nat. Tax J. 219 (1958).

returns with 1959 adjusted gross income of $500,000 or over, the median effective rate was 27.6 per cent, but the effective rates ranged from 0 to 78.4 per cent.[22] Finally, it should be noted that much discussion of tax burdens assumes that the weight of a tax falls on the nominal taxpayer. If the taxpayer can shift part or all of the burden to other persons, however, calculations like Table IV would have to be revised to reflect one's conclusions about the prickly subject of tax "incidence." [23]

In recent years, opponents of progression have centered their hopes on a movement, which has taken several forms, to amend the Constitution to limit the maximum rate for federal income taxation to 25 per cent. The movement apparently drew some strength from a widely publicized essay by Colin Clark, the Australian economist, arguing that "the safe political and economic level of taxation is somewhere near 25 per cent of the national income" and that "beyond this point inflation may become uncontrollable." [24] Although this benchmark referred to the ratio of all types of taxes, national and state, to total national income, it seems to have gained unwarranted currency as a scientific validation of the proposal to limit federal income taxation to 25 per cent of the individual taxpayer's income.

The original plan for combating federal income tax progression, which has been before the states since 1939, was for petitions by the state legislatures for a constitutional convention, a method for proposing amendments that is authorized by Article V of the Constitution, though never yet employed. Some twenty-nine states have adopted such resolutions; only thirty-four are required by the Constitution.[25] But in some states the resolution was vetoed by the governor or later rescinded by the state legislature, and the effect of such action is not clear. Also perplexing is the question whether all resolutions must be adopted within some limited period of time. (The first of the resolutions was adopted in 1939.) Some of the resolutions call for a maximum rate of income tax of 25 per cent, with no escape; others permit the limit to be raised by a vote of three quarters of the members of both Houses of Congress, but only "in the event of a war in which the United States is engaged creating a grave national emergency requiring such action to avoid national disaster." Even in such a case, the action (requiring a consensus not needed for any other action by Congress, including the declaration of war) is effective for a one year period only, though by a similar vote the limit may be raised for successive periods of one year each. It is not clear whether the Korean "police action" would have been a "war" as that term is used in the proposed amendment, nor whether a declaration by Congress that a war had created the requisite emergency would be conclusive on the courts. The limit may be lifted only while the nation is "actively engaged" in war, a qualification that would presumably prevent going above 25 per cent in later

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22 See Hearings on H.R. 8363 (Revenue Act of 1963), Senate Finance Committee, 88th Cong., 1st Sess., Part 1, pp. 278-282. The range of effective rates disclosed by these tables is itself computed by subclasses of income groups, so that the range for individual taxpayers would be even greater.

23 Note 21 supra; see also citations in Selected Bibliography.

24 Clark, The Danger Point in Taxes, Harper's Magazine 67 (December, 1950); Clark, Public Finance and Changes in the Value of Money, 55 Economic J. 371 (1945); for criticisms, see Goode, An Economic Limit on Taxes: Some Recent Discussions, 5 Nat. Tax J. 227 (1952); Tax Institute, The Limits of Taxable Capacity (1953).

It is an irony of contemporary intellectual history that Clark's 25 per cent limit was foreshadowed in his pamphlet, A Socialist Budget, recommending policies for a Labor Government "for a period of transition to Socialism," published by the British New Fabian Research Bureau in 1935.

25 Constitutional Limitation on Federal Income, Estate, and Gift Tax Rates (Joint Committee on the Economic Report and House Select Committee on Small Business), 82d Cong., 2d Sess. (1952); Packard, The Need to Limit Federal Taxes, 32 Taxes 151, 154 (1954).

years to pay veterans' benefits, to pay off a war-occurred debt, or even to pay the interest on war bonds.

The Constitution is silent on the powers of a constitutional convention, and it is possible that its authority would be unlimited. Partly because of the possibility that a convention would have the power to rewrite the Constitution (although its proposals would still be subject to ratification in the same manner as amendments proposed in the usual manner by Congress), and partly because of other uncertainties in the use of a convention, the tax limitation movement turned to the more traditional way of amending the Constitution — by an amendment proposed by a two-thirds vote of both Houses of Congress and submitted for ratification to the states.

In 1951, the so-called first Reed-Dirksen Amendment was introduced, imposing the familiar 25 per cent limit as the maximum rate for federal income taxation. Like the state proposal, this amendment provides for a suspension of the limit by a vote of three fourths of the membership of both Houses of Congress in time of war when necessary "to avoid national disaster." It also permits the limit to be raised, by a similar vote, to 40 per cent at any time, for one or more periods of one year each. This proposal was later modified to permit Congress by a three-fourths vote to exceed the limit at any time, except that the top rate (if above 25 per cent) may never be more than 15 percentage points above the bottom rate. While enlarging the power of Congress to suspend the 25 per cent limit, the modified proposal would restrict the degree of progression even in wartime, by requiring the top and bottom rates to be separated by no more than 15 percentage points.[26]

It has been estimated that the 25 per cent limit on income taxation would have reduced federal revenues by $16 billion, using 1951 income levels as the basis of comparison. Corporate income tax liabilities would have accounted for $14 billion of this revenue loss and individual income tax liabilities for $2 billion. If this loss was not made up by a reduction in expenditures or by federal borrowing, some additional tax or taxes would have been necessary, and the most likely would be a federal sales tax. It has been estimated that a tax of 10 per cent on all retail sales, or 15 per cent on all retail sales except food, would have been necessary to fill the gap.[27]

In the early nineteen fifties, the Reed-Dirksen proposals seemed to be making some headway, but by 1962, a special committee of the American Bar Association (which had endorsed the idea of a constitutional amendment) concluded that "in the foreseeable future, it seems utterly impossible to secure the adoption of such an amendment." [28] Perhaps so. If revived, the income tax limitation movement, like the attack on other aspects of the federal income tax, must eventually come to grips with the problem of alternative sources of federal revenue, unless deficit spending is to be employed or the level of expenditures is drastically cut. Any

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[26] But exemptions would be permissible, so that Congress (by a three-quarters vote) could apparently enact an income tax with exemptions for the taxpayer, his spouse, and his dependents (for example) of $2500 each, with a tax rate of 75 per cent for the first $25,000 above the exemptions and of 90 per cent for all amounts thereafter.

[27] The course of a running debate on the tax limitation movement may be followed in these articles: Griswold, Can We Limit Taxes to 25 Percent? 190 Atlantic Monthly 76 (1952); Dresser, The Case for the Income Tax Amendment: A Reply to Dean Griswold, 39 A.B.A.J. 25 (1953); Dresser, The Reed-Dirksen Amendment: Developments in the 83d Congress, 39 id. 206 (1953); Cary, The Income Tax Amendment: A Strait Jacket for Sound Fiscal Policy, 39 id. 885 (1953); Dresser, The Reed-Dirksen Amendment: A Reply to Professor Cary, 40 id. 35 (1954).

[28] Report of Special Committee on Proposed Constitutional Amendment Relative to Taxes on Incomes, Inheritances and Gifts, 87 A.B.A. Annual Reports (1962) 348; the 1952 report which led to A.B.A. endorsement of the amendment may be found in 77 id. 578 (1952).

tax that is levied as a substitute for the federal income tax will have its own effect on incentives, spending, investment, and the price level; and in predicting these effects, it is necessary to make assumptions about the shifting and incidence of any such alternative tax. Moreover, one must also contend with the taxpayer's sense of fairness: would an abandonment of the progressive principle in the income tax arouse animosity to any other tax that might be imposed in its place, and frustrate its administration? The student who wishes to pursue these problems further will find suggestions in the Bibliography at the end of this introduction.

A Hop, Skip, and Jump Through Federal Tax Procedure[29]

When income tax rates began to soar at the beginning of World War II, it became evident that the old practice of waiting until March 15[30] of each year to collect the tax on the income of the preceding year called for a degree of thrift that many taxpayers lacked and would guarantee a large volume of uncollectible tax liabilities. To meet this problem, Congress enacted the Current Tax Payment Act of 1943, putting wage and salary earners on a withholding basis of tax collections. This system, which has been in effect ever since, covers all wage and salary payments by an employer to an employee, except payments to agricultural and domestic workers and a few other groups. The employee informs his employer of the number of exemptions to which he is entitled, and the employer then computes, either by a formula or by reference to tables prescribed by statute, the amount to be withheld at each pay period from the employee's wages. The employer periodically pays the withheld amounts to the Treasury, and at the end of the year he prepares a Withholding Tax Statement (Form W-2) for each employee. One copy of this form is sent to the Treasury, where it serves as an information return to insure compliance by the employee. Another copy is attached by the employee to his tax return. The amount withheld is credited on his actual liability, and he either pays the balance due or receives a refund if there was an overpayment. If the employee is in the lower tax brackets, the amount withheld will correspond closely, and perhaps exactly, to the tax due, unless he worked irregularly, had outside income, or had deductions exceeding the standard amount assumed by the withholding tables. (An employee who anticipates a tax liability in excess of the amount that would normally be withheld may authorize his employer to withhold additional amounts.) In the fiscal year 1960, $32.7 billion was withheld by employers under this system, as against aggregate tax liability for individuals of $39.5 billion.

Although the withholding system keeps many taxpayers on a current basis, requiring only minor year-end adjustments between the amount withheld and the actual tax liability, there are many gaps in its coverage. Being restricted to wage payments, it does not cover income from self-employment or from investments; and for upper-bracket employees the amounts withheld may be only a small down payment on the actual liability.

For these reasons, the withholding system was buttressed by the "declaration of estimated tax" method of paying taxes currently. Certain taxpayers must file a declaration of "estimated tax" on April 15 of each year (or on a corresponding date if a fiscal year is employed), estimating their tax liability for the current

[29] Tax procedure is examined in more detail in Chapter 10.

[30] The filing date for individual taxpayers on a calendar year basis was extended to April 15 by the 1954 Code. Corporate returns, however, are due on March 15 in the case of calendar year taxpayers. Most non-business taxpayers and many business taxpayers file on the calendar year basis, but a fiscal year may be elected instead, in which event an individual return is due 3½ months, and a corporate return 2½ months, after the fiscal year ends.

year and the amount to be withheld from their wages. Any balance due must be paid in four installments, the first on April 15 (when the declaration is filed) and the others on June 15, September 15, and the following January 15. Declarations of estimated tax must be filed by any person who expects gross income in excess of $10,000 (married persons entitled to file joint returns, heads of households, and certain surviving spouses) or $5000 (others) or who expects gross income in excess of $200 from sources other than wages subject to withholding. (If the estimated tax is less than $40, however, a declaration is not required.) When the tax return itself is filed on April 15 of the following year, payments of estimated tax, like taxes withheld from wages, are credited against the actual tax liability reported on the return, and any balance is either paid by or refunded to the taxpayer, as the case may be. A penalty is imposed by §6654 on a taxpayer who substantially underestimates his tax liability, unless he qualifies for relief under one of several exceptions.

An individual income tax return must be filed by anyone with gross income of $600 or more for the taxable year, unless he is 65 or older, in which case the limit is $1200. A taxpayer whose gross income falls below the limit could have no tax liability, but if any amounts were withheld from his wages or paid on a declaration of estimated tax, he would file a return in order to get a refund.

The simplest return is Form 1040A, the employee's optional return, which may be used by a taxpayer with gross income of less than $10,000 provided (a) he had no income other than wages, dividends, and interest, and (b) not more than $200 of gross income that was not subject to withholding. Form 1040A calls for a statement of the taxpayer's exemptions, his employer's name and address, his wages and other income, and the amount of tax withheld.

Form 1040 is more elaborate. It requires a statement of the taxpayer's exemptions, detailed information about his income from all sources (wages, salaries, dividends, interest, rents and royalties, etc.), and an itemization of his business and personal deductions. (In lieu of itemizing personal deductions, such as charitable contributions, interest, taxes, and extraordinary medical expenses, the taxpayer may take the optional "standard deduction," infra page 328.) A number of supplemental schedules must be completed and attached to Form 1040 if relevant to the taxpayer's circumstances. Thus, if he was engaged in a business or profession, the income and deductions attributable to this activity are reported on Schedule C, and the net profit or loss is carried from Schedule C to Form 1040 itself. Similarly, if the taxpayer sold or exchanged any property, he reports such transactions on Schedule D, and carries the profit or loss on such transactions from Schedule D to Form 1040. Another schedule is employed by farmers (Form 1040F), the net profit or loss being likewise carried over from this schedule to the body of Form 1040. From this information, the taxpayer computes his tax liability, crediting himself with the amounts withheld from his wages or paid on his declaration of estimated tax. He pays the balance due or, in case of an overpayment, informs the Treasury whether he wishes it refunded to him or credited on his declaration of estimated tax for the current year.

Before the enactment of the 1954 Code, corporations were not required to file declarations of estimated tax. Moreover, until 1950, the corporate tax liability was payable in equal quarterly installments after the end of the taxable year; since then, however, the delay in payment has been gradually reduced, so that a corporation on the calendar year basis must pay the tax in equal installments on March 15 and June 15 of the following year, and, if its estimated tax liability exceeds $100,000, the excess must be paid in installments under a pay-as-you-go system similar to that applicable to individuals.

The corporate income tax return is Form 1120. Provision is made on the

return for reconciling differences between the treatment of financial items for tax purposes and their treatment on the regular books of the corporation. Special forms are prescribed for certain categories of corporations, such as life insurance companies, personal holding companies, and others. While an individual is required to file a return only if his gross income is $600 or more, a corporation must file a return without regard to the amount of its gross income or even if the year's operations produced a loss.

Fiduciaries must also file tax returns. A fiduciary who is in charge of an individual's income (e.g., the guardian of a minor or the committee of an incompetent) must file a tax return for the person in his charge, and an executor or administrator must file a final return for the income of a decedent to the date of death. In addition, Form 1041 (fiduciary return) must be filed by the fiduciary for an estate if its gross income for the taxable year is $600 or more and for a trust if its gross income is $600 or more or if it has any taxable income. Generally speaking, the fiduciary deducts any amounts distributable to beneficiaries; these amounts are taxable to the beneficiaries, to be reported on their respective individual returns, and the fiduciary pays a tax only on the balance.

The partnership return requires a special word. A partnership reports its income and deductions on Form 1065 in about the same way that a corporation reports on Form 1120, but the partnership is not a taxable entity. After calculating its profit or loss for the taxable year, the firm reports, on a schedule at the end of Form 1065, how this amount is allocated among the partners by the partnership agreement. No tax is calculated, however, since each partner's share of the firm's profit or loss is reported by him on his individual tax return. The partnership return, then, is an information return, explaining how each partner's share of the firm's profit or loss has been computed.

Many other information returns are also filed with the Treasury. Form W-2, informing the government of an employee's gross wages and of the amount of taxes withheld by the employer, has already been mentioned. Any one who pays, in the course of his trade or business, $600 or more of wages, salaries, fees, commissions, or other compensation not subject to withholding must file Form 1099, and a similar information report is required by §6041 for payments, in the course of the payor's business, of $600 or more of rent, royalties, annuities, or other "fixed or determinable" income.[30a] The information return network was vastly expanded in 1962 by the amendment of §6042 and the enactment of §6049 to require the reporting of dividend and interest payments of $10 or more (subject to certain exemptions). Information regarding many other items, transactions, and persons (e.g., corporate liquidations, organization of foreign corporations, etc.) are also required by the Code and Treasury regulations.

The administrative machinery that is set in motion by the filing of a tax return is described in Chapter 10. After the returns have been checked for mathematical accuracy, examiners select for audit those that most merit further inspection. Their selection is based on the amount and nature of the income and deductions reported, errors apparent on the face of the return, random sampling techniques, and other criteria. In selecting the auditing returns, the revenue agents may obtain data from information returns, deductions claimed by other taxpayers, newspaper accounts of unusual or large-scale financial operations, and tips from informers. The examiner may also resort to a subpoena, if necessary, to examine the taxpayer and others who may have knowledge of his financial affairs.

[30a] The New York Times, October 14, 1960, reported that some winners of the "daily double" had failed to collect their awards because the racetracks were required to report their names on an information return to the Treasury.

When an examiner's audit discloses an error in tax liability, he advises the taxpayer of his finding and attempts to settle the matter by agreement. If an agreement is not reached with the examiner, the taxpayer may have an informal conference with a conferee in the same division, and if no agreement is reached at this level, he may have a formal conference with an appellate staff that is administratively independent of the examiner and his chief. Most disputes are settled within the Internal Revenue Service.

Should no agreement be reached, however, the taxpayer may "go to law." He may refuse to pay an alleged deficiency and file a petition in the Tax Court of the United States (formerly the Board of Tax Appeals), in which event he cannot ordinarily be required to pay the tax until the case is decided.[31] Instead of filing a petition in the Tax Court, the taxpayer may pay the deficiency and sue for a refund (with interest) in a federal District Court or in the Court of Claims. The advantages and drawbacks of the refund route as compared with the Tax Court are considered in Chapter 10. If the dispute involves not a deficiency but a refund (e.g., if after filing a return and paying the reported tax liability, the taxpayer finds that he reported too much income or failed to claim a deduction or credit to which he was entitled), and if the matter cannot be settled at the administrative level, the taxpayer may not go to the Tax Court, whose jurisdiction is restricted to deficiency cases, but must instead sue in the District Court or Court of Claims.

Cases in the Tax Court and in the District Courts go by appeal to the Courts of Appeals and thence by certiorari to the Supreme Court; cases in the Court of Claims may be reviewed only by the Supreme Court.

The Sources of Federal Tax Law in a Nutshell

Taxes are imposed only by statute, and while the lawyer will often err if he does not go beyond the statute in passing on a tax question, the statute should almost always be his starting point. Moreover, this is not a field where the statute is encrusted with the wisdom or folly of the centuries, like the Statute of Frauds, nor is it one where the statute's principal function is to declare or to qualify the common law, like the Uniform Partnership Act or the Negotiable Instruments Law. Seldom in the law is it so essential that the lawyer study his statute intensively; sometimes the judicial decisions are mere embellishments of the handiwork of Congress. At the same time, some areas of tax law, especially where statutory pronouncements were absent, vague, or confused, have been immensely influenced by judicial doctrines of a common law character, created, that is to say, by the courts as case after case came before them — and in these areas the lawyer must be attuned to the judiciary's signals even more than to those of Congress.[32] Moreover, the very detail of the statute is often deceptively clear, since, as the student will find, the courts may exercise their traditional power to disregard form for substance, and to hold that an arrangement that complies with the literal terms of the statute is not within its spirit, just as a deed absolute on its face may be shown to be a mortgage. One of the fascinations of federal tax law is the interplay between the detail of a statute and the creative spirit of the courts; and even the tax attorney who cannot pause to enjoy this interplay must understand it to survive.

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[31] If the Commissioner determines that ultimate collection of the tax would be jeopardized by delay, however, he may levy a jeopardy assessment and seize the taxpayer's property. This drastic procedure is often employed in cases involving fraud, or where it is feared that the taxpayer may dissipate or secrete his property. The government may not ordinarily sell the seized property, however, by virtue of §6863(b)(3).

[32] See Brown, The Growing "Common Law" of Taxation, 1961 So. Calif. Tax Inst. 1.

The "statute" is of course the Internal Revenue Code of 1954. In recommending its enactment, the House Committee on Ways and Means said:

> Your committee has undertaken the first comprehensive revision of the internal-revenue laws since before the turn of the century and the enactment of the income tax. This revision includes a rearrangement of the provisions to place them in more logical sequence, the deletion of obsolete material, and an attempt to express the internal-revenue laws in a more understandable manner. . . .
>
> In addition, to the rearrangement, however, your committee has made many substantive changes in the code.[33]

It is apparent that, while the pre-1954 statute may not rule us from the grave, meditation on its meaning will be profitable, or at least necessary, for some time to come.

The "old" Internal Revenue Code, which was supplanted by the 1954 Code, was enacted in 1939, and was frequently amended in the years 1939-1954. Before 1939, federal income taxes were ordinarily levied by biennial Revenue Acts, but there was so much continuity of statutory language from one Revenue Act to another that permanent legislation in the form of an Internal Revenue Code was not a real break with the past. Before the 1939 Code was enacted, however, the re-enactment of a taxing provision by Congress sometimes carried an implication that a construction of that provision by the courts or by the Treasury was approved. After adoption of the 1939 Code, Congress from time to time altered those sections of the Code that it wished to change, but there was no reason (except when the 1954 Code was adopted) to re-enact satisfactory sections, and hence no occasion for judicial application of the re-enactment rule. While Congressional inaction in the face of an administrative or judicial construction of a statute sometimes leads to the inference that Congress has adopted that interpretation, especially if *other* sections of the same statute have been amended in the meantime, the theory that silence is tantamount to approval has been applied more sparingly than the re-enactment rule. It remains to be seen whether the 1954 Code, where it re-enacts pre-1954 provisions, will be held to blanket in the administrative and judicial construction of these provisions. The 1939 Code was merely a codification of existing law, intended to draw together in one place a mass of statutes scattered throughout the many volumes of the Statutes at Large, and consequently would not support an inference of Congressional approval of existing interpretations. But the 1954 Code is a "comprehensive revision," and when an existing provision of law is accepted and re-enacted by it, there is at least some basis for arguing that no fault was found with the decisions or regulations construing that provision.

Although the Congressional debates ordinarily do not illuminate technical problems of federal taxation, since they are usually concerned primarily with the tax's rates and expected yield, there are occasional exceptions, and then recourse to the Congressional Record is necessary. The Committee Reports, on the other hand, are frequently helpful, and it is common for the courts to rely heavily on them.[34] They are carefully prepared by technicians on the staff of

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33 H.R. Rept. No. 1337, 83d Cong., 2d Sess. 1 (1954); the Senate Finance Committee's report, S. Rept. No. 1622 (1954), is identical on this point.

34 Since 1939, the reports of the House Committee on Ways and Means, the Senate Finance Committee, and the conference committees have been reprinted in the Internal Revenue Bulletin, which is published weekly by the Internal Revenue Service and complied into semi-annual volumes, cited 1963-1 C.B., 1963-2 C.B., etc. The Congressional reports for the period 1913-1939 were reprinted together in a separate number of the Bulletin: 1939-1 (Part 2) C.B.

On the use of such legislative "material" as an aid to the construction of statutes, see Read, MacDonald, and Fordham, Cases on Legislation (2d ed. 1959) 1222-1277.

the Joint Committee on Internal Revenue Taxation (composed of representatives of the House Ways and Means Committee and the Senate Finance Committee, who are assisted by a kind of legislative civil service of tax experts), but the profusion of technical detail in them makes it clear that they evidence the "intent" of Congress only if we apply the doctrine of respondeat superior.[35] Some members of the committee may know little of the content of the committee's reports, and this is a fortiori true of the members of Congress who do not serve on the tax committees, though no doubt some of them know no more about the statute itself.

Occasionally, though more rarely, the courts refer to the hearings before the House and Senate Committees as an aid to construction. Although some of the oral testimony is quite diffuse, interested public and private individuals and groups often present closely reasoned memoranda in support of their positions. If a proposal is accepted, modified, or rejected by the committee after it has been explained by testimony or memorandum, the presentation may be a clue to the meaning of the committee's action and, by extension, to the meaning of the action of Congress. The hearings are printed by the committees in limited quantities, however, and are to be found in only a few libraries.[36]

Second only to the statute and the legislative materials in importance are the Treasury Regulations. Section 7805 of the 1954 Code authorizes the Secretary of the Treasury or his delegate to prescribe "all needful rules and regulations for the enforcement" of the Code. Identical authority was vested in the Secretary by earlier law. In addition, the Secretary is authorized to prescribe Regulations to cover more specific areas, e.g., under §170 of the 1954 Code he may lay down the method of verifying charitable contributions, under §453 he may prescribe how income from certain installment sales is to be reported, and under §472 he is authorized to issue regulations governing use of the last-in-first-out method of accounting for inventories. Regulations issued under these sections are of a quasi-legislative character; Congress has chosen to delegate to the Treasury authority it might have exercised itself. Other Regulations interpret the statute for the guidance of the taxpayers and the staff of the Internal Revenue Service. Whatever their function, Regulations are issued from time to time in the form of Treasury Decisions ("T.D."), which are compiled at irregular intervals as a systematic series of regulations.

The current Regulations bear the key number "1" if related to the income tax provisions of the 1954 Code; "20" or "25" if related to the estate or gift tax

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[35] The preparation of the committee report is described as follows in Blough, The Federal Taxing Process (1952) 75-76:

> Preparation of the Committee report is ordinarily in the hands of the Chief of Staff of the Joint Committee [on Internal Revenue Taxation] and his staff members. The report is customarily divided into two parts. The first is a discussion in non-technical language of the need for the legislation, what the bill provides, and the anticipated impact on various groups of taxpayers. Among the tax staffs this section of the report is referred to as the "guff." Despite this derisive label, the section is very important. The latter part of the Committee report is a technical explanation of what each section of the bill provides. The Legislative Counsel [of the Treasury] and the Treasury tax staff participate in the preparation of the technical section. This part of the report is coming to be known as the "paraphrase"; it consists largely of a paraphrase of each section of the bill with examples showing how the provision presumably would apply in given situations. The Committee members usually listen to a reading of the "guff" before the report is submitted but ordinarily do not go over the "paraphrase," at least not in Committee.

[36] On use by the judiciary of inaccessible legislative history as an aid to the construction of statutes, see Mr. Justice Jackson, concurring, in United States v. Public Utilities Commission, 345 U.S. 295, 319 (1953).

provisions, respectively. Thus, "Regs. §1.170-1" denotes a regulation having to do with §170 (income tax consequences of charitable contributions); "Regs. §20.2041-1" is concerned with §2041 (estate tax treatment of powers of appointment); "Regs. §25.2512-1," with §2512 (value of property in computing gift tax). The last compilations of regulations before enactment of the 1954 Code were known as "Regulations 118" (income tax), "Regulations 105" (estate tax), and "Regulations 108" (gift tax). There are other series for more specialized subjects. Changes in the Regulations are issued as Treasury Decisions, and when the changes have accumulated in quantity, a new compilation is issued. Thus, Regulations 118 was issued in 1953 to supplant Regulations 111, which had been frequently amended by Treasury Decisions after its issuance in 1943. The Administrative Procedure Act, 5 U.S.C. 1003, requires proposed regulations (with certain exceptions) to be published in the Federal Register to permit interested parties to file their objections or suggestions for consideration before adoption.

Regulations, whether of a legislative or an interpretive character, can serve a useful function only if both administrators and taxpayers can rely on them. Seldom are Regulations, of either kind, overturned by the courts, but occasionally a regulation, especially the interpretive type, is invalidated. It is impossible to generalize beyond saying that a regulation that was issued soon after the statute it interprets and that has been adhered to consistently by the government will command great respect from the courts, but that if contemporaneity and consistency are lacking, the courts will be less constrained to accept the regulation. As already mentioned, re-enactment of a statute may carry an implication of Congressional approval of an interpretive regulation,[37] and this doctrine may give the effect of law to some Regulations that were in force when the 1954 Code was enacted. Since this was a comprehensive revision, the re-enactment doctrine may now be applied with greater fidelity to the facts of legislative life than for earlier years when revenue acts often carried over much of the language of earlier acts in the interest of simplicity rather than because administrative interpretations were endorsed. Another problem in this area is whether a proper interpretive regulation, either with or without re-enactment of the underlying statute, in time takes on the force of law so that only Congress, and not the Treasury, may alter it. Partly because the Treasury seldom amends interpretive Regulations except to bring them into harmony with subsequent judicial decisions or new statutes, there is little authority on this subject. Despite earlier doubts, apparently the Treasury may ordinarily amend an interpretive regulation if the new interpretation is to be given prospective force only, and there may also be power to apply it retroactively. Retroactive application may be withheld by the Treasury itself, however, as wise administration, pursuant to its power, now conferred by Section 7805(b) of the 1954 Code, to prescribe the extent to which Regulations and rulings shall be applied prospectively only.[38]

In addition to the Regulations, which are issued by authority of the Secre-

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37 It is hard to assess the importance of the re-enactment rule in this area. It may be only a handkerchief covering something already covered by a blanket if the court would have upheld the regulation, whether the statute had been re-enacted or not; but it may be crucial if the court thinks the regulation when issued was either debatable or demonstrably wrong, but that it gained authority as a result of silent acquiescence by Congress.

38 See Griswold, A Summary of the Regulations Problem, 54 Harv. L. Rev. 398 (1941), which cites a number of other important articles in footnote 1; Feller, Addendum to the Regulations Problem, id. at 1311; Griswold, Postscriptum, id. at 1323. Several important cases were decided after these articles were written: Helvering v. Reynolds, 313 U.S. 428 (1941); American Chicle Co. v. United States, 316 U.S. 450 (1942); Helvering v. Edison Bros. Stores, Inc., 133 F.2d 575, cert.

tary of the Treasury, a steady supply of rulings, instructions, releases, and other lesser pronouncements flows from the Internal Revenue Service. Not bearing the imprimatur of the Secretary, these documents are less authoritative than the Regulations, but they are of great importance in the day-to-day administration of the tax laws, and often they are persuasive to the courts. The most important are letters to taxpayers in response to requests for rulings on past or contemplated transactions and instructions of a more general nature to field offices of the Service. Some rulings are no more than a curt "yes" or "no" to an inquiry; others are more or less elaborately argued interpretations of the Code, Regulations, and judicial decisions. The most commonly encountered current series of such announcements are "Revenue Rulings" and "Revenue Procedures" (abbreviated "Rev. Rul." and "Rev. Proc."); earlier series that are still often cited were issued under the designation "I.T." (rulings to taxpayers on income tax matters), "G.C.M." (General Counsel Memorandum, usually discussions of legal problems of general interest), and "Mim." (Mimeograph, usually instructions to field offices). Many, but by no means all, Revenue Rulings are published in the Internal Revenue Bulletin. For the criteria governing publication, and the status and effect of rulings, see pages 916-923 infra.

Tax litigation commences in the Tax Court of the United States (formerly the Board of Tax Appeals), in the various federal District Courts, and in the Court of Claims. The opinions of the Tax Court fall into two categories: "regular" decisions, which are published by the court itself; and "memorandum" decisions, which are not officially reported but are published commercially by Prentice-Hall, Inc., and by Commerce Clearing House. The opinions of the District Courts, Court of Claims, Courts of Appeals, and Supreme Court are, of course, to be found in the regular federal reports, but the tax cases decided by these courts are also separately published by Prentice-Hall, Inc., in the series American Federal Tax Cases (cited as A.F.T.R.) and by Commerce Clearing House in the series United States Tax Cases (cited as U.S.T.C.). These sets also contain a few District Court opinions in tax cases that are not to be found in the Federal Supplement. A few opinions on federal tax claims are handed down by federal courts sitting in bankruptcy and by state courts passing on probate or receivership matters.

When the Internal Revenue Service loses a case in the Tax Court, the Commissioner often announces, in the Internal Revenue Bulletin, whether he "acquiesces" ("Acq." or "A") or does not acquiesce ("Non-Acq." or "NA") in the decision. Acquiescence operates as advice to the staff of the Service to rely on the decision in the disposition of other cases. Non-acquiescence indicates that the Service, whether it appeals the decision or not, will not accept the principle enunciated in it in disposing of other cases (though of course the decision is binding as to the taxpayer in the case itself, unless reversed on appeal), and that it may litigate the same issue when it arises again. Because decisions of the Tax Court are reviewed by eleven Courts of Appeals, the government may eventually succeed in obtaining a reversal of the Tax Court, even though the decision in the non-acquiesced case was affirmed by a Court of Appeals; indeed, the principal way for the Treasury to get a conflict among the circuits (as a basis for a petition for certiorari) when the Tax Court decides in favor of the taxpayer is to stick to its guns and relitigate the same issue in one or more other cases. After announcing its non-acquiescence, the Treasury may be dis-

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denied, 319 U.S. 752 (1943). See also Davis, Administrative Law (1951) 217-226; White, The Scope of the Treasury's Power to Issue Nonretroactive Regulations, 38 Calif. L. Rev. 292 (1950); Eisenstein, Some Iconoclastic Reflections on Tax Administration, 58 Harv. L. Rev. 477 (1945).

couraged by a series of losses in the Courts of Appeals, or it may reconsider its views for other reasons, and substitute an acquiescence for non-acquiescence.[39] Another administrative practice related to litigation is based on the Treasury's power, already mentioned, to prescribe the extent to which its rulings and regulations will be applied prospectively only. When a judicial decision in the government's favor overrules earlier cases or conflicts with rulings that had been extensively relied on by taxpayers, the Treasury sometimes announces that a new regulation or ruling, issued to conform to the judicial decision, will not be applied retroactively.

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Current problems. Two outstanding collections of comments on income tax problems of current interest are: Tax Revision Compendium (House Ways and

[39] On the Internal Revenue Service's practice of continuing to litigate an issue after losing in one or more federal courts of appeals, in the hope that another appellate court will decide in the government's favor and thus create a more promising basis for exercise of the Supreme Court's certiorari jurisdiction, see infra pages 936-937.

Means Committee, 1959) (3 vols.), and Federal Tax Policy for Economic Growth and Stability (Joint Committee on the Economic Report, 1955); the papers in the latter volume were followed by hearings, published as: Hearings, Subcommittee on Tax Policy of Joint Committee on the Economic Report, 84th Cong., 1st Sess. (pursuant to Public Law 304, §5(a), 79th Cong.). Congressional hearings frequently include material of great interest, though it is often badly indexed and intermingled with partisan exhortation; see especially Hearings on General Revenue Revision, House Ways and Means Committee, 83d Cong., 1st Sess. (1953) (4 vols. organized by subject); Hearings on President's 1961 Tax Recommendations, House Ways and Means Committee, 87th Cong., 1st Sess. (1961) (4 vols.); Hearings on Revenue Act of 1962 (H.R. 10650), Senate Finance Committee, 87th Cong., 2d Sess. (1962) (11 vols. plus index); Hearings on President's 1963 Tax Message, House Ways and Means Committee, 88th Cong., 1st Sess. (1963) (7 vols.); Hearings on Revenue Act of 1963 (H.R. 8363), Senate Finance Committee, 88th Cong., 2d Sess. (1963) (5 vols. plus index). The Joint Economic Committee of Congress publishes occasional studies relating to federal taxation, including The Federal Revenue System: Facts and Problems (various dates), as does the Senate Small Business Committee.

The Brookings Institution, through the National Committee on Government Finance, is sponsoring a series of studies on government finance; the tax studies include Groves, Federal Tax Treatment of the Family (1963); McDonald, Federal Tax Treatment of Income from Oil and Gas (1962); Ott and Meltzer, Federal Tax Treatment of State and Local Government Securities (1963); and others.

The Tax Institute sponsors periodic symposiums on subjects of current interest and publishes the papers and discussions; recent symposiums include Reappraisal of Business Taxation (1961); Economic Effects of Section 102 (1951); and others that are referred to hereafter.

See also the annual proceedings of the National Tax Association and the publications of the Tax Foundation (pamphlets and a periodical, Tax Review).

Comprehensive recent proposals for tax reform may be found in: Smith, Federal Tax Reform (1961), and Hellerstein, Taxes, Loopholes and Morals (1963). Earlier programs for reform of the federal tax structure are: Groves, Postwar Taxation and Economic Progress (1946); Simons, Federal Tax Reform (1950); Paul, Taxation for Prosperity (1947), cc. 27-46; Committee on Postwar Tax Policy, A Tax Program for a Solvent America (1945).

Suggestive, but briefer, recent works include: Cary, Reflections upon the American Law Institute Tax Project and the Internal Revenue Code: A Plea for a Moratorium and Reappraisal, 60 Colum. L. Rev. 259 (1960); Lowndes, Federal Taxation and the Supreme Court, 1960 Sup. Ct. Rev. 222; Sneed, The Rule of Good Law and Federal Taxation, 2 Boston College Indus. & Comm. L. Rev. 203 (1961); Batt, The Gray Fleece of the Crimson Catt: A Primer of Tax Nonsense, 51 Ky. L.J. 187 (1962); Hambrick, The Illusion of Tax Reform, 56 Duke L.J. 56 (1963); Brown, The Growing "Common Law" of Taxation, 1961 So. Calif. Tax Inst. 1; Anthoine, Tax Reduction and Reform: A Lawyer's View, 63 Colum. L. Rev. 808 (1963).

Blough, The Federal Taxing Process (1952), is an excellent account of the way federal revenue laws are drafted, enacted, and administered. For a biting description of the platitudes employed in debates on tax policy, see Eisenstein, The Ideologies of Taxation (1961), discussed by Cahn, Arnold, McDonald, and the author, 18 Tax L. Rev. 1 (1962).

Empirical studies. A series of empirical studies of the effects of federal taxation, conducted under the sponsorship of the Harvard Business School, includes Butters and Lintner, Effect of Federal Taxes on Growing Enterprises (1945); Hall,

Effects of Taxation: Executive Compensation and Retirement Plans (1951); Smith, Effects of Taxation on Corporate Financial Policy (1952);

Legal works. The most comprehensive treatises are Mertens, Law of Federal Income Taxation (various dates), in 15 volumes, and, on procedure and practice, Casey, Federal Tax Practice (4 vols. 1955), both kept up-to-date by pocket part supplements. The Practising Law Institute publishes two excellent collections of pamphlets, systematically covering the subject of federal income taxation, entitled Fundamentals of Federal Taxation and Current Problems in Federal Taxation. Briefer summaries of federal income taxation are: Stanley and Kilcullen, The Federal Income Tax (4th ed. 1961); Haden, Fundamentals of Federal Taxation (1959); and Chirelstein, Day and Owens, Taxation In the United States (Harvard World Tax Series, 1963).

Treatises on particular subjects include: Magill, Taxable Income (rev. ed. 1945) (main problems of defining income); Bittker, Federal Income Taxation of Corporations and Shareholders (1959); Willis, Handbook of Partnership Taxation (1957); Bickford, Successful Tax Practice (1956); Freeman and Freeman, The Tax Practice Handbook (1960). Others are cited at appropriate places hereafter.

The student should also become familiar with the resources, and limitations, of the principal loose-leaf services: Prentice-Hall, Federal Taxes; Commerce Clearing House, Federal Tax Reporter; Rabkin and Johnson, Federal Income, Estate and Gift Taxation.

There are a number of annual tax institutes whose annual proceedings are published, including New York University Institute on Federal Taxation, Southern California Tax Institute, and Tulane Tax Institute.

The February, 1954, draft of a Federal Income Tax Statute, published in two volumes by the American Law Institute, may be profitably compared with the 1954 Code adopted by Congress.

Bibliography. There is a more complete bibliography in Blough, The Federal Taxing Process (1952) 481-494; and the Tax Institute of America publishes a comprehensive bibliography series, Tax Institute Bookshelf.

CHAPTER 1

Introductory: Some Characteristics of Income

The Sixteenth Amendment grants Congress the power "to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." Section 61(a) of the Internal Revenue Code of 1954 announces broadly that:

> Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items. . . .

Section 22(a) of the 1939 Code was more elaborate:

> "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

The committee reports on the 1954 Code state that while the language of §22(a) was simplified, the "all-inclusive nature of statutory gross income has not been affected thereby," and that there was no intention "to change the concept of income that obtains under §22(a)." H.R. Rept. A18; S. Rept. 168.* This introductory chapter is an examination of the outer limits of §61(a). We will leave for later study the various self-denying ordinances by which Congress has excluded from income certain items, or has allowed others to be deducted or credited. We are concerned here only with how far Congress might go if it chooses.

We shall see that the boundaries of the term "income" are hazy and shifting. Yet most transactions and items are either clearly within or clearly without its area. The bulk of our administrative rulings and judicial decisions is concerned with the issues that are met in later chapters of this book — issues which arise only where this chapter leaves off, so to speak. These more frequently litigated issues arise under provisions of the Internal Revenue Code that exclude from taxable income items that could clearly be taxed if Congress chose, that grant preferential treatment to certain kinds of income, and that allow various deductions, exemptions, and credits in computing the amount of tax due. Other areas of dispute are the determination of the proper year for reporting items that are admittedly income to the particular taxpayer in one year or another, and the determination of which of several taxpayers must report items that are undeniably income to one of them. Yet we cannot ignore, even though we less frequently encounter, the question which this chapter asks and seeks to answer: what are the characteristics of income?

The inquiry is a difficult one, and the author should confess at the outset that organizing this chapter has been troublesome. The Supreme Court, which at one time attempted to define "income" in a neat sentence, more recently announced:

* H.R. Rept. No. 1337 and S. Rept. No. 1622, 83d Cong., 2d Sess. (1954). The conference committee's report is H.R. Rept. No. 2543.

In fact, no single, conclusive criterion has yet been found to determine in all situations what is a sufficient gain to support the imposition of an income tax. No more can be said in general than that all relevant facts and circumstances must be considered. [Commissioner v. Wilcox, 327 U.S. 404, 407 (1946).]

The items or transactions that have forced the courts back to a consideration of fundamentals by requiring them to pass on the "outer limits" of the term "income" — thus providing the grist for this chapter — often seem to have little in common with each other. These items are, moreover, ordinarily of minor importance to the generality of taxpayers, and sometimes they are downright bizarre.

Furthermore, despite the fact that we have several times been advised that Congress intended "to use the full measure of its taxing power" in promulgating §22(a) of the 1939 Code, Helvering v. Clifford, infra page 372, it is not always clear whether courts in holding that this or that item is not "income" are excluding it on constitutional grounds or on the theory that it is not within the intended scope of §22(a). As indicated above, §61(a) of the 1954 Code is intended to have the same meaning as §22(a) of the 1939 Code. This would suggest that it does not change the treatment of the items dealt with in this chapter, whether they were believed by the courts to be exempt from taxation on constitutional grounds or only because not within the statutory grasp of §22(a). But the House Report on the 1954 Code states that the term "income" in §61(a) is used "in its constitutional sense," and, as will be seen, there are some instances where it has been thought that §22(a)'s use of the term "income" was not so broad. To add to our difficulty, the Senate Report says that in §61(a) "the word 'income' is used *as in section 22(a)* in its constitutional sense." S. Rept. 168 (emphasis supplied).

The waters are muddied still further by the fact that the Sixteenth Amendment is not the only source of Congressional authority to tax. Article I, Section 8, Clause 1 of the Constitution provides:

The Congress shall have Power to Lay and Collect Taxes, Duties, Imposts, and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts, and Excises shall be uniform throughout the United States.

Direct taxes must by virtue of Article I, Sections 2 and 9, be apportioned among the states according to population (a requirement that makes them totally impracticable), and to the extent that an income tax is a direct tax, recourse must be had to the Sixteenth Amendment for relief from this requirement of apportionment. But to the extent that a tax on income or on anything else is *not* a direct tax, Congress does not have to rely on the Sixteenth Amendment.*

Even though a particular item is not "income" as the term is used in the Sixteenth Amendment, then, it is not necessarily placed beyond the reach of Congress. An indirect tax on the item is authorized by Article I, Section 8, Clause 1. But we then are face to face with a dilemma. For if the item is not "income," can Congress have intended to tax it under an income tax law? Would Congress have desired to add together "income" and other appropriate objects of taxation and levy a single graduated tax on the total? The student will find that the last two questions are hardly acknowledged, let alone answered, by the cases that follow. It has generally been assumed that if an item is not "income," Congress did not intend to tax it under the income tax sections of the Internal Revenue Code.

* For fuller discussion, see Brushaber v. Union Pacific R.R. Co., 240 U.S. 1 (1916); Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926); Penn Mutual Indemnity Co. v. Commissioner, 277 F.2d 16 (3d Cir. 1960); Simmons v. United States, infra page 137.

SELIGMAN, INCOME TAX*

7 Encyclopedia of the Social Sciences 628-629, 630-631 (1932)

The Concept of Taxable Income. As an economic concept income denotes a flow of wealth during a definite period, as opposed to capital as a fund of wealth at a distinct point of time. It may be defined as the money or money's worth which comes in during a definite period over and above the expenses of acquisition. The fiscal concept of income, however, is still subject to dispute. In the nineteenth century Hermann and Schmoller elaborated the free disposition or consumption concept, which regards as income only those receipts of which an individual can dispose without impairing his capital. More common outside Germany was the periodicity concept, which would limit income to regularly recurring receipts. The broadest definition of income for taxation purposes was formulated by Georg Schanz in 1894 and was independently advanced over two decades later by R. M. Haig, who defines income as "the money value of the net accretion to one's economic power between two points of time." This view is in substantial agreement with the accountant's practice of ascertaining the annual profit of an enterprise by comparing the balance sheet at the opening and the close of the year. As a reaction to Schanz, Strutz and Fuisting developed the source concept (Quellentheorie), which would confine taxable income to receipts from permanent sources.

With the exception of the income taxes in Basel and in Bremen, where the broader concept was almost wholly accepted, fiscal practice at the outset inclined toward the narrower interpretation of income. In the course of time, however, the concept was widened, the characteristic of regularity disappeared, while chance or aleatory receipts were subjected to supplementary taxes. At the present time findings, occasional earnings or lottery prizes are everywhere included in income, while inheritances are separately taxed, in part because they constitute irregular or accidental income. Special taxation of gifts is also widespread but is sometimes frustrated by administrative difficulties, as in the American experiment of 1922.† Neither the permanence of the source nor the regularity of the receipt any longer forms a necessary part of the concept of taxable income.

The widening of the income concept, however, brought forth a number of difficult problems. . . .

Another disputed point is the problem of including savings in taxable income. John Stuart Mill claimed that to include savings in income is to impose double taxation — a tax first on the entire income and then again on the yield of the income that has been transmuted into capital. This contention, which has been renewed in recent years by Einaudi and others, suffers from several defects. First, it rests on a confusion between the receipt and the disposition of income. Income may be either spent or saved; but both these actions are subsequent, not anterior, to the receipt. One must have the income before he decides what to do with it. The concept of income is independent of the use to which it is put. Secondly, the double tax argument is a fallacy. In the first year a tax is imposed on the entire income from whatever source derived; in the second year there is similarly imposed a new tax, which is now increased because of the additional income. This is not taxing the same thing twice, it is levying taxes on different things; namely the successive and therefore different incomes. If the individual prefers to save

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† A federal gift tax was imposed by the Revenue Act of 1924 (not 1922), but it was repealed by the 1926 Act. It was reimposed in 1932, however, and is still in effect. — Ed.

rather than to spend his income, his preference is evidently due to the anticipated advantages of his action. But these clearly augment his ability to pay. To refrain from taxing the proceeds of the capital into which the income of the previous year has been transmuted would involve the abandonment not of a double tax, but of a single tax. Thirdly, if savings are not taxed as income then the income tax is transformed into a tax on expenditure, which is the least defensible of all the criteria of ability to pay. While a poor man indeed spends less than a rich man, the disparity in outlay bears no proportion to the disparity in wealth. The richer a man is, the more difficult it is to spend his income and the more automatic his savings become. To tax both Henry Ford and his seven dollar a day employee on their expenditures would be a travesty of justice: the latter has to spend virtually his entire earnings; the former, even with the best of will, can spend only a fraction of his profits. For these reasons no country has ever seriously entertained the idea of excluding savings from taxable income. . . .

Quite an opposite suggestion was advanced by J. A. Hobson, urging that only so much of income should be deemed taxable as constitutes a true surplus. By surplus Hobson means "all rents and all gains for the use of capital, brains or labor which are not a necessary incentive to secure such use." But the essential vagueness of this concept and the almost insuperable difficulties of application, coupled with the well nigh practical identity of the results with those of the existing system of graduated income tax and exemptions, have combined to prevent any hearing for the suggestion.

NOTE

1. *Expenditure taxation.* Despite Seligman's conviction that it would be "a travesty of justice" to exempt savings and to tax only that part of income that is spent by the taxpayer, serious proposals have been made for an expenditures tax. See Kaldor, An Expenditure Tax (1955); Fisher and Fisher, Constructive Income Taxation: A Proposal for Reform (1942); Kust, Tax Reform for the Sixties, New Republic 11 (Jan. 16, 1961).

2. *Other definitions.* For an exhaustive account of attempts to define taxable income, see Wueller, Concepts of Taxable Income, 53 Pol. Sci. Q. 83, 557 (1938), 54 id. 555 (1939).

SURREY and WARREN, THE INCOME TAX PROJECT OF THE AMERICAN LAW INSTITUTE: GROSS INCOME, DEDUCTIONS, ACCOUNTING, GAINS AND LOSSES, CANCELLATION OF INDEBTEDNESS*

66 Harvard Law Review 761, 769-771, 775 (1953)

The American Law Institute through its Tax Project is undertaking a complete examination of the technical provisions of the federal income, estate, and gift tax laws. . . .

Those who seek a precise definition of "income" will not find complete solace in the Draft. On the contrary, as the Comments state, "Attempts to define 'income' have been unsatisfactory." The Eisner v. Macomber definition [infra p. 56] — "Income may be defined as the gain derived from capital and from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets" — is vulnerable on several grounds. For one thing, it is incomplete, for it hardly covers income from a cancellation of indebtedness. And for the hard questions that lie at the periphery it would force a narrow dissection of the terms "capital" or "labor" in place of a broad consideration of the issues. Is the act of picking up found money "labor"? Is the ac-

tivity required in an embezzlement "labor"? Essentially, the Eisner v. Macomber statement is a generalization rather than a definition.

The economists' definitions, apart from the fact that there is no unanimity among economists, are here not desirable. While they are helpful in indicating possible overall objectives of an income tax, they are neither appropriate for statutory use nor intended to be. For example, Henry Simons has defined personal income as "the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question." From the standpoint of tax administration this definition clearly covers too much ground — for example, all forms of imputed income would be included — and hence puts too great a strain on the exclusion sections. For much the same reasons, attempts to solve the problem by starting with all receipts as the taxable base and then subtracting those receipts which should not be taxed are equally unsatisfactory. Such an approach requires at the outset a definition of "receipt." Is a cancellation of indebtedness a "receipt" by the debtor? Does an assignment of income involve a "receipt" by the assignor? Next, it requires an enumeration of all those receipts which should not be taxed, a task which is as difficult as that which would be faced under the economists' definitions. Loans, capital replacements, perhaps imputed income, would have to be specifically excluded since they are "receipts." Our experience will always be insufficient to achieve a satisfactory itemization of all of the desired exclusions. The less rigid term "income" does not involve us in this exclusionary strait jacket. The "receipts" approach is thus neither a simplification nor a clarification of the tax base for an income tax.

The Supreme Court has recognized the futility of attempting to capture the concept of income and confine it within a phrase. In U.S. v. Kirby Lumber Co. [infra p. 89] the Court explicitly abandoned the search for a definition, and succeeding cases have not revived the search. The courts have given a wide scope to the income tax, but have recognized that the borderline content of "income" must be determined case by case. Essentially the concept of income is a flexible one, with the result in a particular case being determined by the interplay of common usage, accounting concepts, administrative goals, and finally judicial reaction to these forces. Each force and judicial reaction in turn reflects an underlying judgment as to what types of receipts should be subject to a tax imposed on "income."

It is believed that this combination of wide inclusiveness and elasticity should be retained, and that a simple reference to "all gains, profits, and income" is sufficient. It is also believed that familiar wording should be continued to avoid generating, by attempts to eliminate linguistic overlapping, new and nebulous problems of definition. Hence the Draft adheres to the old and seasoned terminology of "gains, profits, and income." . . .

In the income tax, as in other complex legislation, the need is for a standard which will project our present aims into the future and serve as the vehicle for solving the unforeseen cases as they arise. The legislative function is not denied or thwarted when other branches of the Government are relied upon by Congress to perform substantial tasks in the application of statutes. Administration and judicial interpretation are necessary parts of the overall process of legislation. The income tax is no exception. The general phrase "gains, profits, and income" is a satisfactory legislative command to the administrator and the judge. It provides a proper balance between the demand of a particular taxpayer that he should not be called upon to pay a tax without prior warning and the demands of all other taxpayers as a group that each particular taxpayer bear his proper part of the tax burden. The phrase is therefore retained in the Draft as a standard to

solve the unforeseen cases until enough wisdom accumulates to build a more complete legislative solution to the problems of the future.

SECTION A. NON-CASH BENEFITS

UNITED STATES v. DRESCHER

179 F.2d 863 (2d Cir. 1950), cert. denied, 340 U.S. 821

Before L. HAND, Chief Judge, and SWAN and CLARK, Circuit Judges.

SWAN, Circuit Judge.

This appeal brings up for review an action against the United States to recover additional income taxes for the years 1939 and 1940 which the plaintiff asserts were illegally assessed and collected. He was an officer and director of Bausch & Lomb Optical Company, and in each of the taxable years the Company purchased from an insurance company at a cost of $5,000 a single premium annuity contract naming him as the annuitant. The taxes in dispute resulted from the Commissioner's including such cost as additional compensation received by the plaintiff in the year when the annuity contract was purchased. The district court awarded the plaintiff judgment for overpayments in the aggregate amount of $5,924.22, ruling that he received no income in 1939 or 1940 attributable to the purchase of the annuity contracts. The correctness of this ruling is presented by the appeal.

The facts are not in dispute. In 1936 the Optical Company inaugurated a plan to provide for the voluntary retirement at the age of 65 of its principal officers then under that age. There were five such, of whom Mr. Drescher was one. He was born April 28, 1894. Pursuant to this plan and in "recognition of prior services rendered," the Company purchased on December 28, 1939, and on the same date in 1940, a single premium, non-forfeitable annuity contract which named Mr. Drescher as the annuitant. Each policy was issued by Connecticut General Life Insurance Company and was delivered to the Optical Company which retained possession of it. It was the Company's intention, and so understood by the annuitant, that possession of the policy should be retained until the annuitant should reach the age of 65. The premium paid for each policy was $5,000. The amount of such payment was deducted by the Company in its tax return for the year of payment as part of the compensation paid to Mr. Drescher during that year. His salary as an officer was not reduced because of the purchase of the annuity contract, and he was not given the option to receive in cash the amounts expended by the Company for the premium payments. In filing income tax returns Mr. Drescher reported on the cash basis; the Optical Company on the accrual basis.

By the terms of the policy the Insurance Company agrees to pay the annuitant, commencing on December 28, 1958, a life income of $54.70 monthly under the 1939 policy and $44.80 monthly under the 1940 policy, with a minimum of 120 monthly payments. If the annuitant dies before receiving 120 monthly payments, the rest of them are payable to the beneficiary named in the policy. Each policy gives the annuitant an option to accelerate the date when monthly payments shall commence, but this option must be exercised by the annuitant in writing and endorsed on the policy. Consequently so long as the Optical Company retains possession of the policy the annuitant cannot exercise the option. If the annuitant dies before December 28, 1958, or before the acceleration date if he has exercised the option to accelerate monthly income payments, a death benefit is payable to the beneficiary designated by him (his wife). The policy reserves to him the right to change the beneficiary. The policy declares that "Neither this contract nor

any payment hereunder may be assigned, and the contract and all payments shall be free from the claims of all creditors to the fullest extent permitted by law." The policy has no cash surrender, salable, or loan value, and does not entitle the annuitant to a distribution of surplus.

This case is governed by the provisions of the Internal Revenue Code as they existed in 1939 and 1940. The appellant contends that the contracts are taxable to the annuitant in the year of purchase by the employer because §22(a) [1939 Code] sweeps into gross income "compensation for personal service, of whatever kind and whatever form paid, . . . and income derived from any source whatever." The taxpayer . . . cites Treasury rulings to the effect that retirement annuity contracts purchased for an employee gave rise to taxable income only as the annuitant received payments under the contract; and that the entire amount of each annuity payment was includible in gross income for the year of its receipt if he had made no contribution toward the purchase of the annuity. . . .

Whether we should construe the statute in accord with these Treasury rulings if the matter were res integra, we need not say. In this court the question of construction is not res integra because of our decision in Ward v. Commissioner, 2 Cir., 159 F.2d 502. That case involved a single premium annuity contract delivered to the annuitant and assignable by him. We there held that "the petitioner became taxable in 1941 upon whatever value was, by the delivery of the policy to him in that year, then unconditionally placed at his disposal. . . . This was the then assignable value of the policy." 159 F.2d page 504. We then considered whether it was error to value the policy in the amount of the premium paid for it. We recognized that the assignable value of the policy in 1941 might be less than the single premium paid for it, but as the purchaser had offered no proof that it was we held that the Tax Court was right in treating "cost to the purchaser as the assignable value of the policy when received by the taxpayer." 159 F.2d page 505.

As we shall not overrule the *Ward* case, the question is narrowed to determining whether the present case is distinguishable because the plaintiff's policies are non-assignable and were retained in the possession of the employer. We do not think these facts are sufficient to distinguish the cases with respect to taxability of the contracts, although they may affect the value of the rights the respective annuitants acquired. It cannot be doubted that in 1939 the plaintiff received as compensation for prior services something of economic benefit which he had not previously had, namely, the obligation of the insurance company to pay money in the future to him or his designated beneficiaries on the terms stated in the policy. That obligation he acquired in 1939 notwithstanding the employer's retention of possession of the policy and notwithstanding its non-assignability. The perplexing problem is how to measure the value of the annuitant's rights at the date he acquired them. The taxpayer contends that they then had no present value, while the appellant argues that their value was equal to the premium paid by the employer. We are unable to accept either contention.

The prohibition against assignment does not prove complete absence of present value. The right to receive income payments which accrued to the plaintiff when the Optical Company received each contract represented a present economic benefit to him. It may not have been worth to him the amount his employer paid for it; but it cannot be doubted that there is a figure, greater than zero although less than the premium cost, which it would have cost him to acquire identical rights. Likewise, the assurance that any beneficiary named by him at the time the contract was executed, or substituted by him at a later date, would in the event of his death receive the cost of each contract, plus interest after a few years, conferred a present economic benefit on him. Whatever present value the life insurance fea-

ture had to him is clearly taxable. See Commissioner v. Bonwit, 2 Cir., 87 F.2d 764, certiorari denied Bonwit v. Helvering, 302 U.S. 694. Another element of value inheres in the possibility that the annuitant could realize cash by contracting with a putative third person to hold in trust for him any payments to be received under the annuity contract. True, the promisee would run the risk that the annuitant might die before becoming entitled to any payment, in which event they would be payable to the beneficiary designated in the policy, but by exercising the reserved power to change the beneficiary the annuitant could designate his promisee. The power to make such a contract based on the policy may well have had some present value. No proof was offered as to this. For reasons which will be stated later the plaintiff had the burden of proving the amount by which he was overtaxed. On the other hand, it seems clear that the policy was worth less to the annuitant than the premium paid because the employer's retention of possession precluded him from exercising the privilege of accelerating the date of annuity payments since the insurance company's approval had to be endorsed upon the policy. The granting of this privilege must have been one of the factors taken into account in fixing the premium — at least, we may so assume in the absence of evidence. Hence deprivation of ability to exercise the privilege would decrease the value of the policy to the annuitant below its cost to the employer.

None of the authorities relied on by the parties is precisely in point on the issue of valuation. In Hackett v. Commissioner, 1 Cir., 159 F.2d 121, although the policy was non-assignable, the value to the annuitant was measured by the cost of the premium. As already stated, that basis is inapplicable here, for retention of the policy by the employer cut off the acceleration privilege. The same distinction exists with respect to the partially assignable policy involved in Oberwinder v. Commissioner, 8 Cir., 147 F.2d 255. And the tax treatment of the assignable policy in that case, as well as of those involved in the *Ward* case and in Hubbell v. Commissioner, 6 Cir., 150 F.2d 516, affords little guidance to a correct valuation here. Likewise, the cases holding free from taxation a nonassignable promise to pay money at a future date do not assist us, since they rest decision on taxability — here concluded by the *Ward* case — rather than on valuation. But it is unnecessary on the present appeal to determine the precise valuation of the policies.

As already mentioned the burden of proving by how much he was overtaxed was on the plaintiff. He had paid the additional taxes assessed upon the valuation ascribed by the Commissioner to the annuity contracts. An action to recover taxes erroneously collected is essentially an action for money had and received and unjustly detained by the defendant. Stone v. White, 301 U.S. 532; DeGuire v. Higgins, 2 Cir., 159 F.2d 921. Hence the plaintiff must show how much was unjustly detained. He relied upon the terms of the contract to prove that it had no present value whatever. But for reasons already stated we are satisfied that the 1939 policy had some present value and since he did not prove that such value was less than $5,000, the judgment in his favor cannot stand. . . .

Judgment reversed and cause remanded.

CLARK, Circuit Judge (dissenting in part).

I agree that the judgment must be reversed, but do not share in the view that some amount less than the $5,000 expended by the employer for this taxpayer in each of the years in question may be found to be the value of the annuity and hence the amount of additional compensation for which he is to be taxed. For the contrary seems to me well supported in reason and well established by the authorities cited in the opinion, some directly in point and some with, I suggest, immaterial variations of fact. In the light of modern conditions of life, the satisfying of the highly natural and indeed burning desire of most men of middle age

to obtain security for their old age and for their widows at death seems so clearly an economic benefit that I wonder it has been questioned as much as it has. Nor do I see the need to support this conclusion by looking for some highly theoretical possibility of turning this benefit into immediate dollars and cents any more than in the case where an employee is furnished living quarters or meals. Just as the latter are valued as additional compensation, though not assigned or assignable, so I think this highly valuable security is a purchased benefit for these company executives. Consequently the making of nice distinctions in either taxability or the amount thereof between assignable or accelerable annuities or their delivery or retention by the company — after careful forethought and advice of its attorneys with naturally an eye on both pension and tax possibilities — seems to me improper, when the general purpose to make adequate retirement provisions for these employees was made so clear.

Hence for any issues here involved I do not think it is important to discover what reasons impelled the employer to make the slightly differing provisions from those before this court in Ward v. Commissioner, 2 Cir., 159 F.2d 502, 505. Perhaps the employer may have had the prescience to foresee these tax problems which are troubling my brothers and did trouble the court below and may result in at least postponement, if not non-collectibility, of most, if not all, of the tax on the additional return provided by the employer for these executives. Perhaps, rather, the employer was providing only for a surer provision "free from the claims of all creditors to the fullest extent permitted by law" for this taxpayer and his wife. So in retaining possession of the policies and cherishing the present intent not to permit acceleration of the annuities, the employer may have had in mind a way of both securing the purchased services to the retirement age in normal cases and guarding against unusual situations due to disability or other special cause. In any event the fact is that the employer purchased at the going insurance rate those contracts which for the parties fulfilled the conditions desired.[1] Actually they would return to the annuitant, or to his widow, total amounts at least well in excess of the premiums paid and increasing yet more the longer he lived. The parties got just what they paid for in the insurance market, and its cost price is the additional compensation the executive received. The two features stressed in the opinion, namely, the nonassignability and the present non-accelerability of the annuities, may add to their usability for the particular purpose, but would seem not to change the basis of value. Perhaps, indeed, they render the contracts more desirable not only to the employer, but also to the annuitant's wife, as making the security provisions less easily impaired, and thus have a special appeal to a husband solicitous of his wife's future. At least, I do not see what basis we have for thinking they adversely affect values of provisions for a particular purpose, viz., security. If, in fact, these conditions do affect the amount of the premium, as the opinion rather naturally assumes, then all the more is the bargain of the parties to be respected as made; even the annuitant would doubtless be interested in a maximum return though it be strictly limited to himself or his wife. It seems to me that there is being set up some premise, not found in any of the precedents, of a fictitious partly-impaired transferability which is now somehow to be given a value in place of the wholly practical values set upon these contracts in the insurance market itself.

Of the cases, Hackett v. Commissioner, 1 Cir., 159 F.2d 121, seems directly in

[1] This was a tightly controlled corporation, so much so that the executives receiving the annuities and their families owned approximately 35 per cent of the voting stock, while the older officers and directors owned approximately 57 per cent. Hence there was never a sharp divergency of interest between these executives and their employer.

point and Judge Mahoney's opinion wholly persuasive as to both the meaning of the statute and the value to be set upon a nonassignable annuity contract. The suggested ground of distinction, that here retention of the policy by the employer cut off the acceleration privilege, cannot be accepted, since there does not appear to have been any such privilege in the annuity there considered; for no mention of the fact, or allusion of any kind to it, is made by the court. The same is true in Oberwinder v. Commissioner, 8 Cir., 147 F.2d 255, which also appears to be on all fours with this case. Similar results were reached in Hubbell v. Commissioner, 6 Cir., 150 F.2d 516, and by this court in Ward v. Commissioner, supra; for the reasons I have stated, the fact that the annuities in these cases were assignable should not make their purchase price any more accurate a gauge of their value than is the purchase price here. A like conclusion has been reached with respect to insurance premiums, Commissioner v. Bonwit, 2 Cir., 87 F.2d 764, certiorari denied Bonwit v. Helvering, 302 U.S. 694, and amounts deposited in the federal Civil Service Retirement Fund, Miller v. Commissioner, 4 Cir., 144 F.2d 287; while no case supporting a lesser valuation has been discovered. True, in the *Ward* case we spoke of the failure of the taxpayer "to show that the contract was not worth as much as it cost." Surely there is nothing in this record to suggest anything different. Here there was even an official of the insurance company to testify to the somewhat ordinary nature of these contracts. That the parties actually got the particular provisions they desired for their purposes does not at all suggest that the policies were overpriced.

Hence unless these benefits are now taxed, this small group of top executives will be given a tax advantage not accruing to less fortunate or less well-advised persons. Such taxation should not be confused or rendered abortive by directions for valuation impossible of execution in any realistic way.

NOTE

1. *Tax results in later years.* If the taxpayer had purchased the annuity contracts with his own funds, there would have been no tax consequences until he began to receive the annuity payments from the insurance company. Each monthly payment would have been in part a taxable receipt of income and in part a non-taxable return of capital, under rules that will be examined infra pages 153-154.

2. *Current statutory provisions.* In 1939 and 1940, when the annuity contracts in question were purchased by the taxpayer's employer, the Internal Revenue Code permitted an employer to establish a pension plan for employees, under which the employee would not be taxed until he began to receive his retirement income. (Mr. Drescher's annuities were not purchased pursuant to such a plan, perhaps because the employer wished to reward its employees ad hoc, rather than commit itself to a "plan.") In 1942, the statutory provisions governing such pension plans were tightened up, in order to prevent favoritism to highly paid employees and stockholding employees; this objective is achieved, at least to some extent, by provisions forbidding discrimination in favor of such employees and requiring a reasonably wide degree of coverage, now embodied in §401(a)(3) and (4) of the 1954 Code. At the same time, the Code was amended to provide explicitly that if an employer purchases an annuity contract for the benefit of an employee, not pursuant to a "qualified" plan, the employee is taxable if his rights are nonforfeitable except for failure to pay future premiums. See 1954 Code, §403(c). In Wilson v. Commissioner, 39 T.C. 362 (1962), a taxpayer attacked the constitutionality of §403(c), to the extent that it required him to report as income the premium paid by his employer for an annuity, arguing that because of his ill health the contract was worth less to him than its cost to the employer. The court rejected his argument, but it is not clear whether its decision is based on a failure of proof or on a broader ground.

3. *Effect of employer's own promise to pay in future.* Would Mr. Drescher have been taxed in 1939 and 1940 if his employer had agreed that for every year of service before

age 65, he would be paid by the employer itself a specified monthly amount commencing at 65? Does an employee who is covered by the federal Social Security system realize taxable income in the year he becomes assured of a pension at 65? Does a federal judge realize taxable income in the year in which he completes enough service so as to be entitled to retire at full pay?

4. *Procedural aspects.* Since the taxpayer reported the cost of the annuity contract as income on his 1939 and 1940 returns and paid the tax, his only remedy was to sue for a refund either in the federal District Court or in the Court of Claims. As to the final paragraph of the majority opinion, the same rule would have been applicable had the taxpayer sued in the Court of Claims. Had the taxpayer omitted the item from his 1939 and 1940 tax returns, and thereafter received a notice of deficiency (or "ninety-day letter") from the Commissioner of Internal Revenue, however, he would have had a choice: either to pay the tax and sue for a refund in the District Court or Court of Claims, or to refuse to pay the tax and sue the Commissioner in the Tax Court (formerly the Board of Tax Appeals). Infra pages 934-935. If he had chosen the latter method of attacking, would he have avoided the problem of proof that faced him in the District Court? A presumption of correctness attends the Commissioner's determination that a deficiency exists, and Rule 32 of the Tax Court Rules provides that, in general, "the burden of proof shall be upon the petitioner." See Rice, Tax, Fact and Fiction: Presumptions in Tax Cases, 1 S.D.L. Rev. 56 (1956); Ness, The Role of Statutory Presumptions in Determining Federal Tax Liability, 12 Tax L. Rev. 321, 328 et seq. (1957).

COMMISSIONER v. LoBUE

351 U.S. 243 (1956)

MR. JUSTICE BLACK delivered the opinion of the Court.

This case involves the federal income tax liability of respondent LoBue for the years 1946 and 1947. From 1941 to 1947 LoBue was manager of the New York Sales Division of the Michigan Chemical Corporation, a producer and distributor of chemical supplies. In 1944 the company adopted a stock option plan making 10,000 shares of its common stock available for distribution to key employees at $5 per share over a 3-year period. LoBue and a number of other employees were notified that they had been tentatively chosen to be recipients of nontransferable stock options contingent upon their continued employment. LoBue's notice told him: "You may be assigned a greater or less amount of stock based entirely upon your individual results and that of the entire organization." About 6 months later he was notified that he had been definitely awarded an option to buy 150 shares of stock in recognition of his "contribution and efforts in making the operation of the Company successful." As to future allotments he was told "It is up to you to justify your participation in the plan during the next two years."

LoBue's work was so satisfactory that the company in the course of 3 years delivered to him 3 stock options covering 340 shares. He exercised all these $5 per share options in 1946 and in 1947,[1] paying the company only $1,700 for stock having a market value when delivered of $9,930. Thus, at the end of these transactions, LoBue's employer was worth $8,230 less to its stockholders and LoBue was worth $8,230 more than before.[2] The company deducted this sum as an expense in its 1946 and 1947 tax returns but LoBue did not report any part of it as income. Viewing the gain to LoBue as compensation for personal services the Commissioner levied a deficiency assessment against him, relying on §22(a)

[1] There may be some question as to whether the first option was exercised in 1945 or 1946. See the discussion, infra, as to when the transactions were completed.

[2] The Commissioner assessed a deficiency on the basis of $8,680 although the record figures show a difference between option price and market value of $8,230. No explanation for the discrepancy appears in the record.

of the Internal Revenue Code of 1939 [§61(a), 1954 Code], which defines gross income as including "gains, profits, and income derived from . . . compensation for personal service . . . of whatever kind and in whatever form paid. . . ."

LoBue petitioned the Tax Court to redetermine the deficiency, urging that "The said options were not intended by the Corporation or the petitioner to constitute additional compensation but were granted to permit the petitioner to acquire a proprietary interest in the Corporation and to provide him with the interest in the successful operation of the Corporation deriving from an ownership interest." The Tax Court held that LoBue had a taxable gain if the options were intended as compensation but not if the options were designed to provide him with "a proprietary interest in the business." Finding after hearings that the options were granted to give LoBue "a proprietary interest in the corporation, and not as compensation for services" the Tax Court held for LoBue. 22 T.C. 440, 443. Relying on this finding the Court of Appeals affirmed, saying: "This was a factual issue which it was the peculiar responsibility of the Tax Court to resolve. From our examination of the evidence we cannot say that its finding was clearly erroneous." 223 F.2d 367, 371. Disputes over the taxability of stock option transactions such as this are longstanding. We granted certiorari to consider whether the Tax Court and the Court of Appeals had given [§61(a)] too narrow an interpretation. 350 U.S. 893.

We have repeatedly held that in defining "gross income" as broadly as it did in [§61(a)] Congress intended to "tax all gains except those specifically exempted." See, e.g., Commissioner v. Glenshaw Glass Co. [infra page 97]. The only exemption Congress provided from this very comprehensive definition of taxable income that could possibly have application here is the gift exemption of [§102(a), 1954 Code]. But there was not the slightest indication of the kind of detached and disinterested generosity which might evidence a "gift" in the statutory sense. These transfers of stock bore none of the earmarks of a gift. They were made by a company engaged in operating a business for profit, and the Tax Court found that the stock option plan was designed to achieve more profitable operations by providing the employees "with an incentive to promote the growth of the company by permitting them to participate in its success." 22 T.C., at 445. Under these circumstances the Tax Court and the Court of Appeals properly refrained from treating this transfer as a gift. The company was not giving something away for nothing.

Since the employer's transfer of stock to its employee LoBue for much less than the stock's value was not a gift, it seems impossible to say that it was not compensation. The Tax Court held there was no taxable income, however, on the ground that one purpose of the employer was to confer a "proprietary interest." [3] But there is not a word in [§61(a)] which indicates that its broad coverage should be narrowed because of an employer's intention to enlist more efficient service from his employees by making them part proprietors of his business. In our view there is no statutory basis for the test established by the courts below. When assets are transferred by an employer to an employee to secure better services they are plainly compensation. It makes no difference that the compensation is paid in stock rather than in money. Section [§61(a)] taxes income derived from compensation "in whatever form paid." And in another stock option case we said that [§61(a)] "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." Commissioner v. Smith, 324 U.S. 177, 181.

[3] The Tax Court noted "that in practically all such cases as the one before us, both the element of additional compensation and the granting of a proprietary interest are present." 22 T.C., at 445. See also Geeseman v. Commissioner, 38 B.T.A. 258, 263.

LoBue received a very substantial economic and financial benefit from his employer prompted by the employer's desire to get better work from him. This is "compensation for personal service" within the meaning of [§61(a)].

LoBue nonetheless argues that we should treat this transaction as a mere purchase of a proprietary interest on which no taxable gain was "realized" in the year of purchase. It is true that our taxing system has ordinarily treated an arm's length purchase of property even at a bargain price as giving rise to no taxable gain in the year of purchase. See Palmer v. Commissioner, 302 U.S. 63, 69. But that is not to say that when a transfer which is in reality compensation is given the form of a purchase the Government cannot tax the gain under [§61(a)]. The transaction here was unlike a mere purchase. It was not an arm's length transaction between strangers. Instead it was an arrangement by which an employer transferred valuable property to his employees in recognition of their services. We hold that LoBue realized taxable gain when he purchased the stock.

A question remains as to the time when the gain on the shares should be measured. LoBue gave his employer promissory notes for the option price of the first 300 shares but the shares were not delivered until the notes were paid in cash. The market value of the shares was lower when the notes were given than when the cash was paid. The Commissioner measured the taxable gain by the market value of the shares when the cash was paid. LoBue contends that this was wrong, and that the gain should be measured either when the options were granted or when the notes were given.

It is of course possible for the recipient of a stock option to realize an immediate taxable gain. See Commissioner v. Smith, 324 U.S. 177, 181-182. The option might have a readily ascertainable market value and the recipient might be free to sell his option. But this is not such a case. These three options were not transferable and LoBue's right to buy stock under them was contingent upon his remaining an employee of the company until they were exercised. Moreover, the uniform Treasury practice since 1923 has been to measure the compensation to employees given stock options subject to contingencies of this sort by the difference between the option price and the market value of the shares at the time the option is exercised. We relied in part upon this practice in Commissioner v. Smith, 324 U.S. 177, 324 U.S. 695. And in its 1950 Act affording limited tax benefits for "restricted stock option plans" Congress adopted the same kind of standard for measurement of gains. §130A, Internal Revenue Code of 1939, as amended, 64 Stat. 942. And see §421, Internal Revenue Code of 1954. Under these circumstances there is no reason for departing from the Treasury practice. The taxable gain to LoBue should be measured as of the time the options were exercised and not the time they were granted.

It is possible that a bona fide delivery of a binding promissory note could mark the completion of the stock purchase and that gain should be measured as of that date. Since neither the Tax Court nor the Court of Appeals passed on this question the judgment is reversed and the case is remanded to the Court of Appeals with instructions to remand the case to the Tax Court for further proceedings.*

Reversed and remanded.

[Mr. Justice Frankfurter and Mr. Justice Clark concurred.]

MR. JUSTICE HARLAN, whom MR. JUSTICE BURTON joins, concurring in part and dissenting in part.

In my view, the taxable event was the grant of each option, not its exercise.

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* On remand, the Tax Court held that the income was realized when the taxpayer gave his notes, rather than when he paid them. LoBue v. Commissioner, 28 T.C. 1317 (1957). — ED.

When the respondent received an unconditional option to buy stock at less than the market price, he received an asset of substantial and immediately realizable value, at least equal to the then-existing spread between the option price and the market price. It was at that time that the corporation conferred a benefit upon him. At the exercise of the option, the corporation "gave" the respondent nothing; it simply satisfied a previously-created legal obligation. That transaction, by which the respondent merely converted his asset from an option into stock, should be of no consequence for tax purposes. The option should be taxable as income when given, and any subsequent gain through appreciation of the stock, whether realized by sale of the option, if transferable, or by sale of the stock acquired by its exercise, is attributable to the sale of a capital asset and, if the other requirements are satisfied, should be taxed as capital gain.[1] Any other result makes the division of the total gains between ordinary income (compensation) and capital gain (sale of an asset) dependent solely upon the fortuitous circumstance of when the employee exercises his option.[2]

The last two options granted to respondent were unconditional and immediately exercisable, and thus present no further problems. The first option, however, was granted under somewhat different circumstances. Respondent was notified in January 1945 that 150 shares had been "allotted" to him, but he was given no right to purchase them until June 30, 1945, and his right to do so then was expressly made contingent upon his still being employed at that date. His right to purchase the first allotment of stock was thus not vested until he satisfied the stated condition, and it was not until then that he could be said to have received income, the measure of which should be the value of the option on that date.

Accordingly, while I concur in the reversal of the judgment below and in the remand to the Tax Court, I would hold the granting of the options to be the taxable events and would measure the income by the value of the options when granted.

NOTE

1. *Origin of the "proprietary" option doctrine.* In Geeseman v. Commissioner (cited in footnote 3 of the Court's opinion), the Tax Court held that the exercise of certain stock

[1] Commissioner v. Smith, 324 U.S. 177, 324 U.S. 695, does not require an opposite result. In that case Smith's employer, Western, had undertaken the management of a reorganized corporation, Hawley, under a contract by which Western was to receive as compensation for its managerial services a specified amount of stock in Hawley if it was successful in reducing Hawley's indebtedness by a stated amount. Western, in turn, gave Smith, who was active in the Hawley reorganization, an option to buy, at the then-existing market price, a fixed share of any Hawley stock received under the management contract. The management contract was successfully performed, and a part of the Hawley stock received by Western — the value of which was of course substantially enhanced by the performance of the contract — was sold to Smith at the option price. Under the peculiar facts of that case — more analogous to an assignment to an employee of a share in the anticipated proceeds of a contract than to the usual employee stock option plan — the Tax Court's finding that the gain that would accrue to Smith upon the successful performance of the management contract was intended as "compensation" to him for his services was no doubt amply justified. But as the Court expressly stated in upholding that finding: "It of course does not follow that in other circumstances not here present the option itself, rather than the proceeds of its exercise, could not be found to be the only intended compensation." Id., at p. 182.

[2] Suppose two employees are given unconditional options to buy stock at $5, the current market value. The first exercises the option immediately and sells the stock a year later at $15. The second holds the option for a year, exercises it, and sells the stock immediately at $15. Admittedly the $10 gain would be taxed to the first as capital gain; under the Court's view, it would be taxed to the second as ordinary income because it is "compensation" for services. I fail to see how the gain can be any more "compensation" to one than it is to the other.

options granted by the Continental Can Company to its employees did not constitute a taxable occasion:

> It is true that the prospective purchasers were selected solely because they were valued employees of Continental Can Co., and there is no doubt that the added interest of these employees and the proprietary attitude toward the company which would result from their ownership of the stock constituted one of the motives for the granting of the option. It is equally obvious, however, that the continued employment of the petitioner was not dependent upon the receipt by him of the right to purchase the stock at less than the market price. The terms and conditions of his employment and the compensation he was receiving were in no way changed by the receipt of the privilege of purchasing the stock. . . . Furthermore the price to be paid by petitioner for the stock was substantial and, if consideration be given to the language of the offer, the margin of difference between the option price and the current market price at the time the option price was fixed, and to the fluctuation of prices on the stock market during the period in which the offer was made, we do not believe that it can be said that the margin of difference between the offering price and the fair market value of the stock was so great as to require the conclusion that the transaction here constituted the payment of compensation. . . . Accordingly we are unable to find in the instant case the elements which would indicate that the transaction was not what its form indicates, that is, a purchase of stock by the petitioner with a view to the subsequent realization of profit through dividends or sale or other disposition of the property.

The Commissioner of Internal Revenue acquiesced in the *Geeseman* case, 1939-1 C.B. 13; the Treasury Regulations were amended to tax the exercise of a stock option only to the extent that the spread "is in the nature of . . . compensation for services rendered or to be rendered"; and the era of the "proprietary" stock option commenced. (There were some earlier cases holding the exercise of stock options non-taxable, but, without Treasury endorsement, they were useless to the taxpayer who wanted to play it safe.) Many stock option plans were cleared in advance by the Internal Revenue Service, but a taxpayer whose employer did not apply for, or was denied, a ruling might find himself in the courts on the question whether his option was "proprietary" or "compensatory."

2. *The Smith case and the 1946 regulation.* The problem took on a new aspect in 1946, a few months after the Supreme Court decided the *Smith* case, cited in *LoBue.* There the Court held that a particular option was issued as compensation and that the "spread" at the time of exercise was taxable to the employee. The Treasury interpreted the decision as a green light to tax the spread in every case, and the Regulations were amended in 1946 to provide that "if property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee."

The 1946 regulation was the center of controversy. Friedman and Silbert, Stock Option and Stock Purchase Plans, 8 N.Y.U. Inst. on Fed. Taxation 433 (1950); Comment, The Treasury's Proposal to Tax Employees' Bargain Purchases: T.D. 5507, 56 Yale L.J. 706 (1947). In 1950, the Senate Finance Committee stated that it "believes these regulations go beyond the decision of the Supreme Court in Commissioner v. Smith, 324 U.S. 177 (1945)." S. Rept. No. 2375, 81st Cong., 2d Sess., reprinted in 1950-2 C.B. 483, 526. The Tax Court continued to apply the *Geeseman* case to options granted before the amended regulation, which was intended to be prospective only, was issued (see Rosenberg v. Commissioner, 20 T.C. 5 (1953)) and, in LoBue v. Commissioner, 22 T.C. 440 (1954), it refused to apply the 1946 regulation to a post-1946 stock option, saying that it believed that the criteria of the *Geeseman* case are "still the most reliable guide to be followed."

3. *Statutory and non-statutory stock options since 1950.* The 1946 regulation, in conjunction with earlier doubts as to the breadth of the *Geeseman* doctrine, discouraged the issuance of employee stock options after 1946. The Revenue Act of 1950 added §130A to the 1939 Code, providing favorable tax treatment for so-called "restricted stock options." As a result of these tax benefits, stock options have once more become a popular device

for compensating corporate employees, especially executives. Section 130A was rewritten in 1954 and again in 1964; see §421, page 524 infra.

In 1959, the 1946 regulation was made inapplicable to employee stock options, and the more elaborate rules of Regs. §1.421-6 were substituted to govern the tax status of employee options not meeting the standards of §421. Unlike the 1946 regulation, the current provisions on "non-statutory" stock options (as amended in 1961) acknowledge the possibility that income is recognizable when the option is granted, and they also provide for situations in which the "spread" at the time of exercise cannot be computed because the employee cannot freely dispose of the stock. In cases decided before the new regulations were issued, the Tax Court held that restrictions on disposition may deprive the stock of a fair market value and thus prevent the assessment of tax when the option is exercised and that the "spread" between cost and fair market value could not be taxed in the year in which the restrictions on transfer expired because it "might be out of all proportion to the compensation involved in the original acquisition of the shares." Lehman v. Commissioner, 17 T.C. 652 (1951); Kuchman v. Commissioner, 18 T.C. 154 (1952).

For recent discussions of non-statutory stock options, see Lefevre, Nonrestricted Stock Options, 20 N.Y.U. Inst. on Fed. Taxation 353 (1962); Kempler, Non-restricted Stock Option Plans: Kuchman and Lehman Cases, 16 Tax L. Rev. 339 (1961).

4. *Stock options granted to independent contractors.* For the status of stock options granted to underwriters and other independent contractors, see Regs. §1.61-15; Victorson v. Commissioner, 326 F.2d 264 (2d Cir. 1964) (income realized by underwriter on exercising stock option); see also Fleischer and Meyer, What Treatment for Non-employee Stock Options? Underwriters' Position Difficult, 14 J. Taxation 274 (1961); Fleischer and Meyer, Tax Treatment of Securities Compensation: Problems of Underwriters, 16 Tax L. Rev. 119 (1960).

5. *Other employee discounts.* Although it is no longer applicable to stock options, Regs. §1.61-2(d)(2) carries forward the 1946 rule that the employee must report the "spread" if he acquires property from his employer for less than its fair market value. Does it apply to goods purchased at an employee's "courtesy" discount, or to meals sold for less than cost in an employee lunchroom?

In Commissioner v. Minzer, 279 F.2d 338, 340 (5th Cir. 1960), the court held that an insurance agent was taxable when he purchased a policy of insurance on his own life from one of the companies he represented, whether he remitted the full premium to the company and received the company's check in the amount of his customary commission or simply deducted the commission at the outset:

> The taxpayer obtained insurance which the companies were prohibited by law from selling to him at any discount. . . . It cannot be said that the insurance had a value less than the amount of the premiums. It must then be said that a benefit inured to the taxpayer to the extent of his commissions. The benefit is neither diminished nor eliminated by referring, as does the Tax Court, to the word "commission" as a verbal trap. The commissions were, we conclude, compensation for services and as such were income within the meaning of §61(a)(1).

BENAGLIA v. COMMISSIONER

36 B.T.A. 838 (1937)

STERNHAGEN: The Commissioner has added $7,845 each year to the petitioner's gross income as "compensation received from Hawaiian Hotels, Ltd.," holding that this is "the fair market value of rooms and meals furnished by the employer." In the deficiency notice he cites article 52[53], Regulations 77,* and holds inapplicable Jones v. United States, 60 Ct. Cls. 552; I.T. 2232; G.C.M. 14710; and

* "Where services are paid for with something other than money, the fair market value of the thing taken in payment is the amount to be included as income. . . . When living quarters such as camps are furnished to employees for the convenience of the employer, the ratable value need not be added to the cash compensation of the employees, but where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax." — ED.

G.C.M. 14836. The deficiency notice seems to hold that the rooms and meals were not in fact supplied "merely as a convenience to the hotels" of the employer.

From the evidence, there remains no room for doubt that the petitioner's residence at the hotel was not by way of compensation for his services, not for his personal convenience, comfort, or pleasure, but solely because he could not otherwise perform the services required of him. The evidence of both the employer and employee shows in detail what petitioner's duties were and why his residence in the hotel was necessary. His duty was continuous and required his presence at a moment's call. He had a lifelong experience in hotel management and operation in the United States, Canada, and elsewhere, and testified that the functions of the manager could not have been performed by one living outside the hotel, especially a resort hotel such as this. The demands and requirements of guests are numerous, various, and unpredictable, and affect the meals, the rooms, the entertainment, and everything else about the hotel. The manager must be alert to all these things day and night. He would not consider undertaking the job and the owners of the hotel would not consider employing a manager unless he lived there. This was implicit throughout his employment, and when his compensation was changed from time to time no mention was ever made of it. Both took it for granted. The corporation's books carried no accounting for the petitioner's meals, rooms, or service.

Under such circumstances, the value of meals and lodging is not income to the employee, even though it may relieve him of an expense which he would otherwise bear. In Jones v. United States, supra, the subject was fully considered in determining that neither the value of quarters nor the amount received as commutation of quarters by an Army officer is included within his taxable income. There is also a full discussion in the English case of Tennant v. Smith, H.L. (1892) App. Cas. 150, III British Tax Cases 158. A bank employee was required to live in quarters located in the bank building, and it was held that the value of such lodging was not taxable income. The advantage to him was merely an incident of the performance of his duty, but its character for tax purposes was controlled by the dominant fact that the occupation of the premises was imposed upon him for the convenience of the employer. The Bureau of Internal Revenue has almost consistently applied the same doctrine in its published rulings.

The three cases cited by the respondent, Ralph Kitchen, 11 B.T.A. 855; Charles A. Frueauff, 30 B.T.A. 449; and Fontaine Fox, 30 B.T.A. 451, are distinguishable entirely upon the ground that what the taxpayer received was not shown to be primarily for the need or convenience of the employer. Of course, as in the *Kitchen* case, it can not be said as a categorical proposition of law that, where an employee is fed and lodged by his employer, no part of the value of such perquisite is income. If the Commissioner finds that it was received as compensation and holds it to be taxable income, the taxpayer contesting this before the Board must prove by evidence that it is not income. In the *Kitchen* case the Board held that the evidence did not establish that the food and lodging were given for the convenience of the employer. In the present case the evidence clearly establishes that fact, and it has been so found.

The determination of the Commissioner on the point in issue is reversed.

Reviewed by the Board.

Judgment will be entered under Rule 50. MURDOCK concurs only in the result.

ARNOLD, dissenting: I disagree with the conclusions of fact that the suite of rooms and meals furnished petitioner and his wife at the Royal Hawaiian Hotel were entirely for the convenience of the employer and that the cash salary was fixed without reference thereto and was never regarded as part of his compensation.

Petitioner was employed by a hotel corporation operating two resort hotels

in Honolulu — the Royal Hawaiian, containing 357 guest bed rooms, and the Moana, containing 261 guest bed rooms, and the bungalows and cottages in connection with the Moana containing 127 guest bed rooms, and the Waialae Golf Club. His employment was as general manager of both hotels and the golf club.

His original employment was in 1925, and in accepting the employment he wrote a letter to the party representing the employer, with whom he conducted the negotiations for employment, under date of September 10, 1925, in which he says:

> Confirming our meeting here today, it is understood that I will assume the position of general manager of both the Royal Waikiki Beach Hotel (now under construction) and the Moana Hotel in Honolulu, at a yearly salary of $10,000.00, payable monthly, together with living quarters, meals, etc., for myself and wife. In addition I am to receive $20.00 per day while travelling, this however, not to include any railroad or steamship fares, and I to submit vouchers monthly covering all such expenses.

While the cash salary was adjusted from time to time by agreement of the parties, depending on the amount of business done, it appears that the question of living quarters, meals, etc., was not given further consideration and was not thereafter changed. Petitioner and his wife have always occupied living quarters in the Royal Hawaiian Hotel and received their meals from the time he first accepted the employment down through the years before us. His wife performed no services for the hotel company.

This letter, in my opinion, constitutes the basic contract of employment and clearly shows that the living quarters, meals, etc., furnished petitioner and his wife were understood and intended to be compensation in addition to the cash salary paid him. Being compensation to petitioner in addition to the cash salary paid him, it follows that the reasonable value thereof to petitioner is taxable income. Cf. Ralph Kitchen, 11 B.T.A. 855; Charles A. Frueauff, 30 B.T.A. 449.

Conceding that petitioner was required to live at the hotel and that his living there was solely for the convenience of the employer, it does not follow that he was not benefited thereby to the extent of what such accommodations were reasonably worth to him. His employment was a matter of private contract. He was careful to specify in his letter accepting the employment that he was to be furnished with living quarters, meals, etc., for himself and wife, together with the cash salary, as compensation for his employment. Living quarters and meals are necessities which he would otherwise have had to procure at his own expense. His contract of employment relieved him to that extent. He has been enriched to the extent of what they are reasonably worth.

The majority opinion is based on the finding that petitioner's residence at the hotel was solely for the convenience of the employer and, therefore, not income. While it is no doubt convenient to have the manager reside in the hotel, I do not think the question here is one of convenience or of benefit to the employer. What the tax law is concerned with is whether or not petitioner was financially benefited by having living quarters furnished to himself and wife. He may have preferred to live elsewhere, but we are dealing with the financial aspect of petitioner's relation to his employer, not his preference. He says it would cost him $3,600 per year to live elsewhere.

It would seem that if his occupancy of quarters at the Royal Hawaiian was necessary and solely for the benefit of the employer, occupancy of premises at the Moana would be just as essential so far as the management of the Moana was concerned. He did not have living quarters or meals for himself and wife at the Moana and he was general manager of both and both were in operation during the years before us. Furthermore, it appears that petitioner was absent

from Honolulu from March 24 to June 8 and from August 19 to November 2 in 1933, and from April 8 to May 24 and from September 3 to November 1 in 1934 — about 5 months in 1933 and 3½ months in 1934. Whether he was away on official business or not we do not know. During his absence both hotels continued in operation. The $20 per day travel allowance in his letter of acceptance indicates his duties were not confined to managing the hotels in Honolulu, and the entire letter indicates he was to receive maintenance, whether in Honolulu or elsewhere, in addition to his cash salary.

At most the arrangement as to living quarters and meals was of mutual benefit, and to the extent it benefited petitioner it was compensation in addition to his cash salary, and taxable to him as income.

The Court of Claims in the case of Jones v. United States, relied on in the majority opinion, was dealing with a governmental organization regulated by military law where the compensation was fixed by law and not subject to private contract. The English case of Tennant v. Smith, involved the employment of a watchman or custodian for a bank whose presence at the bank was at all times a matter of necessity demanded by the employer as a condition of the employment. The facts in both these cases are so at variance with the facts in this case that they are not controlling in my opinion.

SMITH, TURNER and HARRON agree with this dissent.

NOTE

1. *Origin and history of "employer's convenience" doctrine.* Before the 1954 Code was enacted, there was no statutory provision dealing with meals and lodging supplied by employers to employees. Apparently the American source for the "convenience of the employer" doctrine was Jones v. United States, cited in the *Benaglia* case:

> If the nature of the services require the furnishing of a house for their proper performance, and without it the service may not be properly rendered, the house so furnished is part of the maintenance of the general enterprise, an overhead expense, so to speak, and forms no part of the individual income of the laborer. . . . It is indeed far from impressive that where an employer, in the course of the promotion and efficiency of the enterprise in which he is engaged, must of necessity provide the indispensable facilities for the successful prosecution of the same, because perchance an employee in the not to be avoided course of his duties may be in a position to avoid an expense which in a different character of service he might be obliged to incur, that therefore the use of the facility constitutes income. 60 Ct. Cl. 552, 575, 577 (1925).

The Regulations for many years contained a provision exempting the value of meals and quarters furnished to the employee "for the convenience of the employer." For the years 1933 and 1934 (involved in the *Benaglia* case), the provision was as set out in the footnote, supra page 46. From 1940 until the 1954 Code was enacted, the phraseology was as follows:

> If a person receives as compensation for services rendered a salary and in addition thereto living quarters or meals, the value to such person of the quarters and meals so furnished constitutes income subject to tax. If, however, living quarters or meals are furnished to employees for the convenience of the employer, the value thereof need not be computed and added to the compensation otherwise received by the employees. [Regs. 118, §39.22(a)-3.]

In 1950, the Internal Revenue Service issued Mim. 6472, 1950-1 C.B. 15, stating:

> The "convenience of the employer" rule is simply an administrative test to be applied only in cases in which the compensatory character of such benefits is not otherwise determinable. It follows that the rule should not be applied in any case in

which it is evident from the other circumstances involved that the receipt of quarters or meals by the employee represents compensation for services rendered.

Under this construction of the Regulations, the Internal Revenue Service took the position that a state civil service employee employed at a state institution was taxable on the value of meals and quarters if they were treated as part of his compensation by the state's civil service rules and regulations, even though he was required to live at the institution in order to be available for duty at all times. This position was not without judicial support (see Martin v. Commissioner, 44 B.T.A. 185 (1941), and Brasher v. Commissioner, 22 T.C. 637 (1954)), but it was rejected (at least for pre-1950 years) in Diamond v. Sturr, 221 F.2d 264 (2d Cir. 1955), because a flat exemption of any meals and lodging supplied for the convenience of the employer, in the opinion of the court, had "persisted through the interpretations of the Treasury and the Tax Court throughout years of reenactment of the Internal Revenue Code." The court also pointed out that in the case before it, a husband and wife were both receiving meals and lodging as housefather and housemother at a state training school for delinquent boys. Only the husband would be taxable under Mim. 6472, however, because his meals and lodging were treated as compensation by state law, while "for reasons obscured by the intricacies of the New York Civil Service system" his wife's were not.

Should meals and lodging be excluded from income? See Bittker, The Individual as Wage Earner, 11 N.Y.U. Inst. on Fed. Taxation 1147 (1953).

2. *1954 Code, §119.* Section 119 of the 1954 Code should be examined with care. To what extent is earlier law modified? Is it now necessary to determine whether meals or lodging are "intended as compensation"? Even though §119 provides that the terms of an employment contract or state statute are not "determinative," are they significant in deciding whether the meals or lodging are excluded by §119? Lodging is excluded only if the employee "is required to accept such lodging on the business premises of his employer as a condition of his employment." Does this automatically insure that the lodging was furnished "for the convenience of the employer"? Can meals be excluded even if the employee is not "required to accept" them "as a condition of his employment"? Was this requirement omitted from §119(1) only because employers do not customarily force-feed their employees, or is there some difference between meals and lodging so far as the requirements of acceptance as a condition of employment is concerned?

Do meals and lodging furnished for the employee's wife and children qualify for exclusion under §119?

On the meaning of "business premises of the employer," see United States v. Barrett, 321 F.2d 911 (5th Cir. 1963) (for state police, every road and highway, and evidently adjacent restaurants as well, constitute "business premises").

In most cases, the requisite "employer's convenience" is established by proof that the employee is "on call" outside of business hours. But see Setal v. Commissioner, ¶61,156 P-H Memo T.C., holding that meals and lodging furnished by a mining company at a company town in a mountainous area of California were provided for the "convenience of the employer" because the closest alternative facilities were 67 miles away by roads that were hazardous in winter; the same facts established that the lodging was a required condition of employment within the meaning of §119(2).

In Rev. Rul. 59-409, 1959-2 C.B. 48, the Internal Revenue Service ruled that the value of meals and lodging furnished by a school to resident faculty members (required to live on the premises to maintain order) and their families were not covered by §119: (a) when students were not in residence (in the absence of evidence that the faculty member's continued presence was required at such times); and (b) to the extent of the value of meals and lodging supplied to the faculty member's family, wife and children. The ruling was withdrawn, no reason being given, by Rev. Rul. 60-348, 1960-2 C.B. 41. What is the status of meals and lodging supplied to an employee's family?

For the status of meals and lodging received by individual proprietors and partners while at work, see Commissioner v. Robinson, 273 F.2d 503 (3d Cir. 1959).

3. *Cash allowances.* What is the status of meals and lodging that are provided by the employer to enable the employee to perform his duties more effectively, but that are charged against his salary? As originally promulgated, the Regulations under §119 pro-

vided that the value of meals and lodging could not be excluded if the employee was "required to reimburse the employer." Regs. §119-1(c)(2). In Boykin v. Commissioner, 260 F.2d 249 (8th Cir. 1958), however, the court held that the rental value of lodging furnished by an employer was excludable under §119 even though it was considered a part of the employer's compensation and was deducted from his salary. The Internal Revenue Service acquiesced in this decision, and in 1962 the Treasury proposed an amendment to the Regulations to bring them into conformity with this decision. Rev. Rul. 59-307, 1959-2 C.B. 48; 27 Fed. Reg. 12836 (Dec. 27, 1962).

What are the scope and purpose of §119's requirement that the meals and lodging be furnished "by" the employer? If the employer requires the employee to live and eat in a restricted area so as to be "on call," but does not want to go into the hotel or restaurant business, can a cash allowance paid to the employee to enable him to obtain suitable meals and lodging be excluded from income? Does the answer depend upon whether the purveyor of the meals and lodging is an "agent" of the employer or an "independent contractor"? See Regs. §119-1(c)(2), providing that such allowances "are includible in gross income to the extent that [they] constitute compensation"; this sentence is carried forward without change in the proposed amendments of December 27, 1962, referred to in the preceding paragraph.

If an employee is not allowed to exclude a cash allowance under §119, can he deduct the cost of the meals and lodging as business expenses under §162? See page 226 infra.

4. *Administrative and social security aspects of meals and lodging.* What are the administrative problems of taxing compensation in kind? See Guttentag, Leonard, and Rodewald, Federal Income Taxation of Fringe Benefits: A Specific Proposal, 6 Nat. Tax J. 250 (1953). Other tax and regulatory statutes must also cope with compensation in kind. See Comment, Tax Treatment of Compensation in Kind, 37 Calif. L. Rev. 628 (1949). Under the Social Security Act, the Treasury has issued regulations providing:

> Ordinarily, facilities or privileges (such as entertainment, medical services, or so-called "courtesy" discounts on purchases), furnished or offered by an employer to his employees generally, are not considered as remuneration for employment if such facilities or privileges are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, good will, contentment, or efficiency of his employees. The term "facilities or privileges," however, does not ordinarily include the value of meals or lodging furnished, for example, to restaurant or hotel employees, or to seamen or other employees aboard vessels, since generally these items constitute an appreciable part of the total remuneration of such employees. [Regs. §31.3121(a)-1(f).]

Is there any justification for including meals and quarters when calculating the employer's social security taxes and the employee's benefits but excluding them in computing the employee's income tax? See Pacific American Fisheries v. United States, 138 F.2d 464 (9th Cir. 1943).

See generally Macauley, Fringe Benefits and Federal Tax Treatment (1959).

5. *Other fringe benefits.* Consider the tax status of these three individuals: A works for $75 a week for the X Company, which makes available to its employees a cafeteria serving inexpensive meals, medical and dental service caring for the entire family, an extensive program of social and recreational activities, and a discount on purchases of its goods. These "fringe benefits" cost the employer, on the average, $5 weekly per employee. B receives $80 a week in identical employment for the Y Company, which offers its employees no such benefits. C receives $77.50 for identical work at Z Company, which offers no fringe benefits, but which has more pleasant lighting, air-conditioning, and foremen. These attractions cost Z Company about $2.50 weekly per employee.

Section B. Imputed Income

VICKREY, AGENDA FOR PROGRESSIVE TAXATION*

18-19, 24-25, 32-33, 44-47, 48-50 (1947)

I. Imputed Income from Assets

Home Ownership

Among the non-monetary items to be evaluated as part of income or spendings, the two most frequently mentioned are the rental value of owner-occupied homes and the value of homegrown produce consumed on the farm. Of these two the more important, in terms of securing an adequate progression of the tax, is imputed net rental. Home ownership tends to increase with increasing income, particularly in urban areas. However desirable home ownership may be as a social institution, the omission of this imputed net rent from the present federal income tax base is hardly the most appropriate or the most effective method of promoting home ownership. Even if a subsidy of home ownership should be considered proper, this particular form is inefficient, for the subsidy is greatest at the top of the income scale where the need for such a stimulus is least.

Present Discriminations. — The discrimination involved in ignoring imputed net rent may be seen from the following example. *A* may rent his home with the $800 income he gets from $20,000 worth of securities, while *D* sells $10,000 of securities and buys a similar home with the proceeds, using the $400 income from his remaining securities to pay taxes and maintenance costs and to set aside against the depreciation of the property. With no tax, *A* and *D* are in the same position economically, but under the present federal tax law not only does *D* have only $400 to report as income as compared with *A*'s $800, but from that $400, *D* will be able to deduct that part used to pay property and other taxes on the home. . . .

Consumer Durables Generally

Miscellaneous Consumer Durables. — From imputed rental it is only a slight generalization to the problem of imputed income from the ownership of other durable consumer goods. The problem is essentially similar, although of smaller magnitude. Consider an individual *A* who has $25,000 of securities and uses the income to rent a furnished dwelling, as compared with a comparable individual *B* who uses the income from $20,000 of securities to rent an unfurnished dwelling, uses the proceeds from the sale of $3,000 worth of securities to buy furnishings and uses the income from the remaining $2,000 to replace the furnishings as they wear out. If no allowance is made for such income, *A* will pay a heavier tax than *B*. If the yield is 4%, *A* will have to pay tax on $1,000 a year, *B* on only $880, though there is no difference in their real situation such as would warrant such a tax differential. Similarly if *B* sells $1,000 worth of securities and buys a phonograph and records with the proceeds, while *A* uses the $40 annual income from the securities to buy tickets to concerts, *A* will pay more tax than *B*, though his real income is quite comparable.

All forms of durable consumer goods give rise to an imputed income in this way, although the discrimination is not so patent if the item in question is not

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commonly rented, and the services derived by the owner are of a type not comparable to any service commonly furnished separately.

Services of Debtors (Interest in Kind)

Bank Deposits. — In addition to the services of durable consumer goods as such, services in kind are sometimes rendered to the owners of certain types of assets in a way that is usually overlooked in determining income or consumption. One of the clearest cases of this is the service rendered by a bank to its depositors. For example, *A* may have a $500 bond, yielding $20 a year in interest and a checking account with little or no balance, so that he must pay the bank $20 a year in service charges. *B*, on the other hand, might sell the bond and deposit the proceeds, thus keeping a balance large enough so that there are no service charges to pay. Both *A* and *B* would be in the same economic position; but under usual methods of computing income, *B* would pay the smaller tax. . . .

Prepayments. — Another source of this type of imputed income is the purchase of goods or services in advance. Probably the most important instance of this is the purchase of fire and casualty insurance a year or more in advance. For example, *A* may purchase a five-year policy for $50, while *B* pays $12 annually for the same policy, or $2 a year more. Perhaps $1 of this difference may be due to economies in billing and the like, but about $1 per year will be the interest at about 4% on the average balance of $25, which *A* has invested in his policy. To equalize the tax on *A* and *B* it will be necessary to include in *A*'s income the $1 of interest earned on his deposit by the insurance company, which the insurance company presumably passes on to him in the form of insurance services and protection. . . .

III. Self-Service and Leisure

A taxpayer may not only consume some of the products he himself produces but he may also "consume" his own services. These services may nor may not be the same as those he normally sells to others: the principle involved is the same in either case, but the discrimination appears more distinctly when the services are of the same sort. For example, if a carpenter who has some carpentering to be done around his home were to stay home from his regular job a day or two to do it, then under the present income tax law (and under most concepts of income which have been translated into statistics), we do not consider this work as producing any income either individually or nationally. On the other hand, if he were to stay at his regular job and hire another carpenter to do the work, his income is increased by the amount earned, although the real situation has not substantially altered. Obviously the value of the work done at home should in principle be added to the income. The same principle holds, though the case is not so striking, if an accountant stays at home to do some amateur plumbing instead of working and using his earnings to hire a professional plumber. In a modern industrial economy with division of labor carried to considerable lengths, such cases are not likely to be frequent enough to constitute a serious problem.

Housework of Wives

The really important case of consumption of one's own services is that of the housework done by wives. If two housewives were to agree to do each other's work for pay, the income reported under present laws would be greater than if they each do their own work. An arrangement of just that sort is rather infrequent, but there are a large number of cases where a wife will go to work and employ a servant to do the work she formerly did herself. For the wife to thus

engage in "gainful" employment will increase the real family income only by the amount by which the wife's money earnings exceed the wages and keep of the servant. Where rates of tax are high and no allowance is made in the income tax base for income (or alternatively for expense) of this character the tax may seriously inhibit the entrance of married women into gainful occupations.

In wartime, when the manpower shortage is acute, the effects are serious. Even though the wife may require a full- or part-time servant if she goes to work, her productivity will often be greater than that of the servant or, at least, than her contributions as a housewife to the short-run output. In peacetime and particularly in time of unemployment there may be a plea that married women should stay at home anyhow; but even if this objective were accepted, a tax differential of this sort is hardly a desirable method of bringing about this result. From a strictly economic point of view the discrimination is patent, and the effect on the national income and the general welfare may be substantial; some allowance, no matter how arbitrary, is imperative. Even though the measurement of either the imputed income from the wife's efforts in the case where she stays at home, or the expenses attributable to her remunerative employment be extremely difficult, the magnitude of the problem and the frequency with which it occurs demand that it be given close attention. . . .

Objectives and Difficulties. — Fundamentally, the objective is to provide that if a wife is on the margin of deciding whether to take a job or to stay and do the housework the tax should not affect the decision; that is, the tax should be the same whichever she does. On this basis, one would either exempt from tax the minimum amount of the wife's earnings that would be necessary to persuade her to take a job, or add to the tax base of the non-working wife the maximum wage that could be offered without inducing her to take a job, or some equivalent combination of credit and imputed income would be required. The amount involved in such credits and additions would presumably vary with the other income of the family as well as with other factors. To attempt to determine such a quantity for each individual case would of course be completely impractical. On the other hand, to set up an arbitrary schedule related to family income would not be satisfactory either. The fundamental difficulty is that unless a tax is assessed on the imputed income from self-service and leisure in the case of single persons and husbands, or alternatively a very liberal earned income credit provided, any attempt to eliminate the effect of the tax on the employment of wives will necessarily involve discriminations and inconsistencies.

As an alternative, one might suggest the deduction from income of the expenses incurred because the wife works.* But this is also unsatisfactory, for the line between expenses that really take the place of the services of the wife and the additional services that can be afforded because of the increased income of the family is extremely difficult to draw, even if the expenses arising as a result of the wife's decision to go to work can be segregated. Other adjustments than the provision of substitute services may be made. Alternative expenditures may be made in rather subtle ways. Groceries may be purchased by telephone from a store offering delivery service instead of at the "cash and carry"; meals may be eaten more often in restaurants; higher prices may be paid generally because of lack of time for leisurely shopping; quarters may be of a different type, etc. . . .

The Non-Employed

The imputed income from the wife's industry has its counterpart in the case of the husband or single person who lives on a property income rather than from

* The 1954 Code, for the first time, authorized a deduction, much circumscribed by restrictions, for the child care expenses of the working mother and certain other persons. See §214, examined infra page 210. — Ed.

personal earnings. Though this difference is considerably less important in the aggregate amount involved, in the degree of choice open to the individual and in the importance of the difference to the individual, it merits consideration. In general, a person who voluntarily refrains from productive activity may be considered to be consuming his own services, or at least consuming his potential services in the form of leisure. At one extreme, this leisure may be valued at what the individual could earn by giving up the leisure and engaging in remunerative employment. But to tax a person on what he could earn if he would (which is what this would amount to), instead of on what he actually does earn, is probably somewhat harsh, inasmuch as the tax is payable in money and the individual under those circumstances might well not have the wherewithal to pay the tax. Assessment of such a tax would be rather like levying a heavy fine for vagrancy, graduated according to the talents of the victim, with the likelihood that alternative penalties might have to be invoked. In practice this issue is not likely to be taken up, since it may be extremely difficult to determine when idleness is voluntary (or perverse) and hence indicative of an imputed leisure income, and when it is involuntary and decidedly not productive of imputed income. There is already sufficient difficulty in distinguishing between voluntary and involuntary unemployment in the occupationally fairly well-defined groups of people covered by unemployment compensation: the difficulties of extending this to miscellaneous occupations, professions, and trades would be considerable.

But without attempting to evaluate leisure as such, there is a very real and concrete sense in which the cost of living of the gainfully occupied may exceed that of the individual who lives on property income exclusively. The employed person is under the necessity of living near his place of work, which in many cases means increased cost of housing. He usually has certain expenses for carfare to and from work, for clothing suitable to the work, and possibly other incidental items which cannot well be allowed as specific deductions from gross income. Particularly if he is single, he will probably have to pay to have certain services such as laundry, household cleaning, and possibly cooking done for him which he might, if at leisure, do for himself in his free time. Again, if single, he will probably spend more for food, being unable to prepare it himself, and whether married or single may have to spend more for lunches and so on. Shopping may be done in a more hurried and less thrifty fashion. Thus even in a strict monetary sense, there is a substantial difference in the real income of a person who earns an income and one who obtains the same money income from property.

NOTE

1. *Estimates of imputed income.* In Goode, Imputed Rent of Owner-occupied Dwellings Under the Income Tax (Brookings Institution, 1961), the additional federal income tax liability that would have accrued in 1958 if (a) imputed net rent for owner-occupied non-farm dwellings had been taxable, and (b) the personal deductions for mortgage interest and property taxes had been eliminated, is estimated at $3.2 billion; no estimate is given, for want of adequate information, for farm dwellings. The author also concludes that the progressivity of the income tax would not have been greatly altered, at least for most of the income range above $2000. The net value of owner-used consumer durable goods is not estimated, but the value of consumers' equities in such goods at the end of 1956 is estimated at $125 billion, compared with owners' equities of $240 billion in owner-occupied non-farm houses.

2. *Legal status of imputed income.* Apparently the only Supreme Court comment on the taxation of imputed income is in Helvering v. Independent Life Ins. Co., 292 U.S. 371 (1934), involving §245 (b) of the Revenue Act of 1921, the predecessor of §804(c)(3) of the 1954 Code. In the case of real estate owned and occupied by a life insurance company, maintenance expenses, taxes, and depreciation could be deducted only if the taxpayer in-

cluded in income the rental value of the real estate. The taxpayer asserted that the provision constituted a direct tax on the real estate, which was unconstitutional because not apportioned by population. The Court held that since deductions are a matter of legislative grace, Congress might qualify any deduction that it chose to allow. If the taxpayer did not wish to take the deductions, it was not required to include the rental value in income; thus, the rental value operated simply as a limitation on deductions that Congress could have denied entirely. The Court also said, however, that a tax on the rental value of a building (i.e., if the taxpayer were *required* to include the rental value in income) would be a "direct" tax within the meaning of Article I, Section 9, Clause 4 of the Constitution, valid only if apportioned among the states in proportion to population, and that it was not excused from the requirement of apportionment by the Sixteenth Amendment, because the rental value of a building occupied by its owner is not "income."

Section 1087 m-2(a) of the Wisconsin Income Tax Law of 1911 provided that "the term 'income' shall include . . . estimated rental of residence property occupied by the owner." This provision was upheld in Income Tax Cases, 148 Wis. 456, 134 N.W. 673, 135 N.W. 164 (1912). The United States Supreme Court dismissed a writ of error on procedural grounds and refused to comment on the substantive issue involved. Bolens v. Wisconsin, 231 U.S. 616 (1914). In the Revenue Acts of 1864, 1865, 1867, and 1870, Congress specifically rejected recommendations by the Commissioner of Internal Revenue that the "rental value of any homestead used or occupied by any person, or by his family, . . . be included and assessed as part of the income of such person." 13 Stat. 281 (1864), 14 Stat. 478 (1867), 16 Stat. 258 (1870); see Smith, The United States Federal Internal Tax History from 1861-1870, pp. 58, 62, 76 (1914).

See Hatch v. Employment Security Agency, 313 P.2d 1067 (Idaho, 1957), holding that a carpenter was ineligible for unemployment benefits during a period when he was constructing a residence for his family, on the ground that a substantial part of the fair market value of the house "must be regarded as remuneration for the work he did while not otherwise employed," under the state unemployment law. Two judges dissented.

3. *References.* Goode, supra paragraph 1; Marsh, The Taxation of Imputed Income, 58 Pol. Sci. Q. 514 (1943); Balch, Individual Income Taxes and Housing, 11 Nat. Tax J. 168 (1958).

SECTION C. THE REQUIREMENT OF A "REALIZATION"

EISNER v. MACOMBER
252 U.S. 189 (1920)

MR. JUSTICE PITNEY delivered the opinion of the Court.

This case presents the question whether, by virtue of the Sixteenth Amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913.

It arises under the Revenue Act of September 8, 1916, which, in our opinion . . . plainly evinces the purpose of Congress to tax stock dividends as income.

The facts, in outline, are as follows:

On January 1, 1916, the Standard Oil Company of California, a corporation of that state, out of an authorized capital stock of $100,000,000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits invested in plant, property, and business and required for the purposes of the corporation, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913, the balance thereafter. In January, 1916, in order to readjust the capitalization, the board of directors decided to issue additional shares sufficient to constitute a stock dividend of 50 per cent of the outstanding stock, and to transfer from surplus account to capital stock account an amount equivalent to such issue. Appro-

priate resolutions were adopted, an amount equivalent to the par value of the proposed new stock was transferred accordingly, and the new stock duly issued against it and divided among the stockholders.

Defendant in error, being the owner of 2,200 shares of the old stock, received certificates for 1,100 additional shares, of which 18.07 per cent, or 198.77 shares, par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916.* She was called upon to pay, and did pay under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of $19,877 because of the new shares; and an appeal to the Commissioner of Internal Revenue having been disallowed, she brought action against the Collector to recover the tax. In her complaint she alleged the above facts, and contended that in imposing such a tax the Revenue Act of 1916 violated Article 1, Sec. 2, Cl. 3, and Article 1, Sec. 9, Cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment. . . .

The Sixteenth Amendment must be construed in connection with the taxing clauses of the original Constitution and the effect attributed to them before the amendment was adopted. In Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, under the Act of August 27, 1894 (28 Stat. 509, 553, c. 349, Sec. 27), it was held that taxes upon rents and profits of real estate and upon returns from investments of personal property were in effect direct taxes upon the property from which such income arose, imposed by reason of ownership; and that Congress could not impose such taxes without apportioning them among the states according to population, as required by Article 1, Sec. 2, Cl. 3, and Section 9, Cl. 4, of the original Constitution.

Afterwards, and evidently in recognition of the limitation upon the taxing power of Congress thus determined, the Sixteenth Amendment was adopted, in words lucidly expressing the object to be accomplished: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income. . . .

A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property,

* The par value of the dividend shares issued by the corporation was $25,000,000, and this figure, rather than their market value, was used in assessing the tax. The record, which consists chiefly of the taxpayer's complaint and the government's demurrer, does not disclose why; but this method being more favorable to the taxpayer than market value, it was not challenged by her. Of the $25,000,000 par value, about 82 per cent was charged by the corporation against surplus and undivided profits earned before March 1, 1913, and the remaining 18 per cent was charged against post-March 1, 1913, surplus and undivided profits. Tr. p. 5. Since the statute provided that a distribution of pre-1913 earnings and profits was non-taxable (infra p. 647), only 18 per cent of the total par value was treated as income to the shareholders. For the taxpayer in Eisner v. Macomber, this meant that about 18 per cent of the aggregate par value of her dividend shares was taxable.

As to market values, the complaint alleges that the taxpayer owned 2200 shares with a market value of $360-382 per share during the month before the dividend was declared and that during the month after the declaration her 2200 original and 1100 dividend shares were worth $234-268 per share, so that "the value of the capital stock owned by each stockholder, including the plaintiff's shares, was substantially unchanged by reason of the declaration of said stock dividend and the issue of additional shares of stock." Tr. pp. 4-5. — Ed.

real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

In order, therefore, that the clauses cited from Article 1 of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not "income," as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose we require only a clear definition of the term "income," as used in common speech, in order to determine its meaning in the amendment, and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

After examining dictionaries in common use, we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (Stratton's Independence v. Howbert, 231 U.S. 399, 415; Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185), "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* Case, 247 U.S. 183, 185.

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. "Derived-from-capital"; "the gain-derived-from-capital," etc. Here we have the essential matter: *not* a gain accruing to capital; not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value, proceeding from the property, severed from the capital, however invested or employed, and coming in, being "derived" — that is, received or drawn by the recipient (the taxpayer), for his separate use, benefit and disposal — that is income derived from property. Nothing else answers the description.

The same fundamental conception is clearly set forth in the Sixteenth Amendment — "incomes, from whatever source derived" — the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

Can a stock dividend, considering its essential character, be brought within the definition? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it. . . .

Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate

share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return. If he desires to dissociate himself from the company he can do so only by disposing of his stock.

For bookkeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a "capital stock account." If profits have been made and not divided they create additional bookkeeping liabilities under the head of "profit and loss," "undivided profits," "surplus account," or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property; and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding-up of the company) does the stockholder realize a profit or gain which becomes his separate property, and thus derive income from the capital that he or his predecessor has invested. . . .

A "stock dividend" shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment. . . .

We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock,

either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock of a corporation should receive in common with other stockholders a 50 per cent stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having six-fifteenths instead of six-tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock; it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power — that "right preservative of rights" in the control of a corporation. Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax. . . .

We have no doubt of the power or duty of a court to look through the form of the corporation and determine the question of the stockholder's right, in order to ascertain whether he has received income taxable by Congress without apportionment. But, looking through the form, we cannot disregard the essential truth disclosed, ignore the substantial difference between corporation and stockholder, treat the entire organization as unreal, look upon stockholders as partners, when they are not such, treat them as having in equity a right to a partition of the corporate assets, when they have none, and indulge the fiction that they have received and realized a share of the profits of the company which in truth they have neither received nor realized. We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical fact but because it is only by recognizing such separateness that any dividend — even one paid in money or property — can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

Conceding that the mere issue of a stock dividend makes the recipient no richer than before, the government nevertheless contends that the new certificates measure the extent to which the gains accumulated by the corporation have made him the richer. There are two insuperable difficulties with this: In the first place, it would depend upon how long he had held the stock whether the stock dividend indicated the extent to which he had been enriched by the operations of the company; unless he had held it throughout such operations the measure would not hold true. Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term.

The complaint contains averments respecting the market prices of stock such as plaintiff held, based upon sales before and after the stock dividend, tending to show that the receipt of the additional shares did not substantially change the market value of her entire holdings. This tends to show that in this instance market quotations reflected intrinsic values — a thing they do not always do. But we regard the market prices of the securities as an unsafe criterion in an inquiry

such as the present, when the question must be, not what will the thing sell for, but what is it in truth and in essence.

It is said there is no difference in principle between a simple stock dividend and a case where stockholders use money received as cash dividends to purchase additional stock contemporaneously issued by the corporation. But an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend, such as the one we have under consideration, where nothing of value is taken from the company's assets and transferred to the individual ownership of the several stockholders and thereby subjected to their disposal. . . .

Upon the second argument,* the Government, . . . virtually abandoning the contention that a stock dividend increases the interest of the stockholder or otherwise enriches him, insisted as an alternative that by the true construction of the Act of 1916 the tax is imposed not upon the stock dividend but rather upon the stockholder's share of the undivided profits previously accumulated by the corporation; the tax being levied as a matter of convenience at the time such profits become manifest through the stock dividend. If so construed, would the act be constitutional?

That Congress has power to tax shareholders upon their property interests in the stock of corporations is beyond question; and that such interests might be valued in view of the condition of the company, including its accumulated and undivided profits, is equally clear. But that this would be taxation of property because of ownership, and hence would require apportionment under the provisions of the Constitution, is settled beyond peradventure by previous decisions of this court.

The Government relies upon Collector v. Hubbard (1870), 12 Wall. 1, 17, which arose under §117 of the Act of June 30, 1864, c. 173, 13 Stat. 223, 282, providing that "the gains and profits of all companies, whether incorporated or partnership, other than the companies specified in this section, shall be included in estimating the annual gains, profits, or income of any person entitled to the same, whether divided or otherwise." The court held an individual taxable upon his proportion of the earnings of a corporation although not declared as dividends and although invested in assets not in their nature divisible. Conceding that the stockholder for certain purposes had no title prior to dividend declared, the court nevertheless said (p. 18): "Grant all that, still it is true that the owner of a share of stock in a corporation holds the share with all its incidents, and that among those incidents is the right to receive all future dividends, that is, his proportional share of all profits not then divided. Profits are incident to the share to which the owner at once becomes entitled provided he remains a member of the corporation until a dividend is made. Regarded as an incident to the shares, undivided profits are property of the shareholder, and as such are the proper subject of sale, gift, or devise. Undivided profits invested in real estate, machinery, or raw material for the purpose of being manufactured are investments in which the stockholders are interested, and when such profits are actually appropriated to the payment of the debts of the corporation they serve to increase the market value of the shares, whether held by the original subscribers or by assignees." In so far as this seems to uphold the right of Congress to tax without apportionment a stockholder's interest in accumulated earnings prior to dividend declared, it must be regarded as overruled by Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 627, 628, 637. Conceding Collector v. Hubbard was inconsistent with the doctrine of that case, because it sustained a direct tax upon prop-

* Eisner v. Macomber was argued in 1919 and reargued by order of the Court in 1920. — Ed.

erty not apportioned among the States, the Government nevertheless insists that the Sixteenth Amendment removed this obstacle, so that now the *Hubbard Case* is authority for the power of Congress to levy a tax on the stockholder's share in the accumulated profits of the corporation even before division by the declaration of a dividend of any kind. Manifestly this argument must be rejected, since the Amendment applies to income only, and what is called the stockholder's share in the accumulated profits of the company is capital, not income. As we have pointed out, a stockholder has no individual share in accumulated profits, nor in any particular part of the assets of the corporation, prior to dividend declared.

Thus, from every point of view, we are brought irresistibly to the conclusion that neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder. The Revenue Act of 1916, in so far as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of Article I, §2, cl. 3, and Article I, §9, cl. 4, of the Constitution, and to this extent is invalid notwithstanding the Sixteenth Amendment.

Judgment affirmed.

MR. JUSTICE HOLMES dissenting. . . .

I think that the word "incomes" in the Sixteenth Amendment should be read in "a sense most obvious to the common understanding at the time of its adoption." . . . For it was for public adoption that it was proposed. McCulloch v. Maryland, 4 Wheat. 316, 407. The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax. . . .

MR. JUSTICE DAY concurs in this opinion.

MR. JUSTICE BRANDEIS delivered the following dissenting opinion:

Financiers, with the aid of lawyers, devised long ago two different methods by which a corporation can, without increasing its indebtedness, keep for corporate purposes accumulated profits, and yet, in effect, distribute these profits, among its stockholders. One method is a simple one. The capital stock is increased; the new stock is paid up with the accumulated profits; and the new shares of paid-up stock are then distributed among the stockholders pro rata as a dividend. If the stockholder prefers ready money to increasing his holding of the stock in the company, he sells the new stock received as a dividend. The other method is slightly more complicated. Arrangements are made for an increase of stock to be offered to stockholders pro rata at par, and, at the same time, for the payment of a cash dividend equal to the amount which the stockholder will be required to pay to the company, if he avails himself of the right to subscribe for his pro rata of the new stock. If the stockholder takes the new stock, as is expected, he may endorse the dividend check received to the corporation and thus pay for the new stock. In order to ensure that all the new stock so offered will be taken, the price at which it is offered is fixed far below what it is believed will be its market value. If the stockholder prefers ready money to an increase of his holdings of stock, he may sell his right to take new stock pro rata, which is evidenced by an assignable instrument. In that event the purchaser of the rights repays to the corporation, as the subscription price of the new stock, an amount equal to that which it had paid as a cash dividend to the stockholder.

Both of these methods of retaining accumulated profits while in effect distributing them as a dividend had been in common use in the United States for many years prior to the adoption of the Sixteenth Amendment. They were recognized

equivalents. Whether a particular corporation employed one or the other method was determined sometimes by requirements of the law under which the corporation was organized; sometimes it was determined by preferences of the individual officials of the corporation; and sometimes by stock market conditions. Whichever method was employed the resultant distribution of the new stock was commonly referred to as a stock dividend. . . .

It is conceded that if the stock dividend paid to Mrs. Macomber had been made by the more complicated method pursued by the Standard Oil Company of Kentucky; that is, issuing rights to take new stock pro rata and paying to each stockholder simultaneously a dividend in cash sufficient in amount to enable him to pay for this pro rata of new stock to be purchased * — the dividend so paid to him would have been taxable as income, whether he retained the cash or whether he returned it to the corporation in payment for his pro rata of new stock. But it is contended that, because the simple method was adopted of having the new stock issued direct to the stockholders as paid-up stock, the new stock is not to be deemed income, whether she retained it or converted it into cash by sale. If such a different result can flow merely from the difference in the method pursued, it must be because Congress is without power to tax as income of the stockholder either the stock received under the latter method or the proceeds of its sale; for Congress has, by the provisions in the Revenue Act of 1916, expressly declared its purpose to make stock dividends, by whichever method paid, taxable as income. . . .

Hitherto powers conferred upon Congress by the Constitution have been liberally construed, and have been held to extend to every means appropriate to attain the end sought. In determining the scope of the power the substance of the transaction, not its form has been regarded. . . . Is there anything in the phraseology of the Sixteenth Amendment or in the nature of corporate dividends which should lead to a departure from these rules of construction and compel this court to hold, that Congress is powerless to prevent a result so extraordinary as that here contended for by the stockholder? . . .

Mr. Justice Clarke concurs in this opinion.

NOTE

1. *The birth of a doctrine.* The decision in Eisner v. Macomber had been avidly awaited by the financial world, especially since a number of corporations had announced that stock dividends would be declared if held non-taxable. When Mr. Justice Pitney began to read his opinion, its import was misunderstood by a representative of Dow, Jones & Company, and a report that the Court had held the dividend taxable was sent out on the ticker. A collapse of stock prices, especially of those corporations which had previously been expected to declare stock dividends, resulted. After the false report was corrected, there was a rebound, sending prices up more than they had dropped. One observer blamed the incident on the fact that Supreme Court opinions are read "in a low or mumbling tone" and added: "I have heard that a committee of stockbrokers is going to investigate the occurrence." New York Times, March 9, 1920, p. 1.

Eisner v. Macomber has been included at this point because of its discussion of the term "income." The subsequent statutory and judicial treatment of stock dividends must be reserved for detailed examination later. Infra pages 689-692.

2. *Some implications of the decision.* If Congress can impose taxes on telephone service, club dues, stock transfers, and the purchase or sale of jewelry, why does the majority in the *Macomber* case conclude that a tax on the receipt of a stock dividend is unconstitutional? Does the decision imply that the increase in the value of property could not be

* This was an unrelated transaction, used by Mr. Justice Brandeis only for purposes of illustration. — Ed.

taxed to a donor of property when he gives it away, or to a decedent for the year in which he dies and transmits the property by will?

See infra page 431, for a proposal to impose an income tax on appreciation in property held at the time of owner's death, advanced by President Kennedy in 1963 but not enacted.

Note Mr. Justice Brandeis' description of a "simple" method by which a corporation can retain its accumulated profits and "yet, in effect distribute these profits, among its shareholders." Would it be still more simple for the directors to declare no dividends, either in cash or in stock, and advise the shareholders that if they want cash they can realize on the increase in the value of their investment by selling some of their original shares? Does the Brandeis dissent imply that shareholders could be required to report their unrealized appreciation (the increase in value between the beginning of the taxable year and its end) as income each year?

Despite the assertion in the penultimate paragraph of the majority opinion of Eisner v. Macomber that "what is called the stockholder's share in the accumulated profits of the company is capital, not income," Congress requires the United States shareholders of foreign personal holding companies and of certain other foreign corporations to report their proportionate share of corporate income even though it is accumulated by the corporation rather than distributed to them. The relevant provisions are §551 (foreign personal holding companies) and §951 ("controlled" foreign corporations). Under §1373, the undistributed income of so-called "Subchapter S corporations" is also taxed directly to the shareholders, but this provision is elective rather than compulsory.

3. *The views of commentators.* No other income tax case has been as extensively and acutely discussed as Eisner v. Macomber. A classic article by Thomas Reed Powell is, Stock Dividends, Direct Taxes, and the Sixteenth Amendment, 20 Colum. L. Rev. 536 (1920); he concludes that the majority Justices are better economists than the minority but finds a "stalemate" in the legal battle. E. R. A. Seligman, the distinguished economist, supported the majority, Studies in Public Finance, c. 5 (1925), while his son, an attorney, preferred the dissents, Implications and Effects of the Stock Dividend Decision, 21 Colum. L. Rev. 313 (1921). Henry Simons, who ordinarily had little use for the views of Seligman père, nevertheless agreed with him in approving the result of the decision, though he could not accept the Court's reasoning:

> The decision that stock dividends should be ignored in calculating taxable income (except for the appropriate changes in the basis from which capital gains and losses are measured) was eminently sound, as a judgment about a question of legislative policy. It is most unfortunate, however, that a constitutional issue was ever raised; for brief experience with the legislation in question would almost certainly have led to general disapproval and early repeal. . . . Actually, an utterly trivial issue was made the occasion for injecting into our fundamental law a mass of rhetorical confusion which no orderly mind can contemplate respectfully, and for giving constitutional status to naive and ridiculous notions about the nature of income and the rationale of income taxes. [Simons, Personal Income Taxation 198-199 (1938).]

But see Surrey, The Supreme Court and the Federal Income Tax: Some Implications of the Recent Decisions, 35 Ill. L. Rev. 779 (1941): "The cornerstone was laid, but the Court proceeded no further with its task of building upon it a concept of income. Each succeeding opinion paid its respects to the principle of realization which was the core of the Court's pronouncement in Eisner v. Macomber, but went on to a result which never matched the rigor of that pronouncement."

Does the case that follows retreat from the "rigor" of Eisner v. Macomber?

HELVERING v. BRUUN

309 U.S. 461 (1940)

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The controversy had its origin in the petitioner's assertion that the respondent realized taxable gain from the forfeiture of a leasehold, the tenant having erected a new building upon the premises. The court below held that no income had

been realized. Inconsistency of the decisions on the subject led us to grant certiorari. . . .

The Board of Tax Appeals made no independent findings. The cause was submitted upon a stipulation of facts. From this it appears that on July 1, 1915, the respondent, as owner, leased a lot of land and the building thereon for a term of ninety-nine years.

The lease provided that the lessee might, at any time, upon giving bond to secure rentals accruing in the two ensuing years, remove or tear down any building on the land, provided that no building should be removed or torn down after the lease became forfeited, or during the last three and one-half years of the term. The lessee was to surrender the land, upon termination of the lease, with all buildings and improvements thereon.

In 1929 the tenant demolished and removed the existing building and constructed a new one which had a useful life of not more than fifty years. July 1, 1933, the lease was cancelled for default in payment of rent and taxes and the respondent regained possession of the land and building.

The parties stipulated

> that as at said date, July 1, 1933, the building which had been erected upon said premises by the lessee had a fair market value of $64,245.68 and that the unamortized cost of the old building, which was removed from the premises in 1929 to make way for the new building, was $12,811.43, thus leaving a net fair market value as at July 1, 1933, of $51,434.25, for the aforesaid new building erected upon the premises by the lessee.

On the basis of these facts, the petitioner determined that in 1933 the respondent realized a net gain of $51,434.25. The Board overruled his determination and the Circuit Court of Appeals affirmed the Board's decision.

The course of administrative practice and judicial decision in respect of the question presented has not been uniform. In 1917 the Treasury ruled that the adjusted value of improvements installed upon leased premises is income to the lessor upon the termination of the lease. The ruling was incorporated in two succeeding editions of the Treasury Regulations. In 1919 the Circuit Court of Appeals for the Ninth Circuit held in Miller v. Gearin, 258 F. 225, that the regulation was invalid as the gain, if taxable at all, must be taxed as of the year when the improvements were completed.

The regulations were accordingly amended to impose a tax upon the gain in the year of completion of the improvements, measured by their anticipated value at the termination of the lease and discounted for the duration of the lease. Subsequently the regulations permitted the lessor to spread the depreciated value of the improvements over the remaining life of the lease, reporting an aliquot part each year, with provision that, upon premature termination, a tax should be imposed upon the excess of the then value of the improvements over the amount theretofore returned.

In 1935 the Circuit Court of Appeals for the Second Circuit decided in Hewitt Realty Co. v. Commissioner, 76 F.2d 880, that a landlord received no taxable income in a year, during the term of the lease, in which his tenant erected a building on the leased land. The court, while recognizing that the lessor need not receive money to be taxable, based its decision that no taxable gain was realized in that case on the fact that the improvement was not portable or detachable from the land, and if removed would be worthless except as bricks, iron, and mortar. It said, 76 F.2d at page 884:

> The question as we view it is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a

part of it, something which, though it increases its value, has no value of its own when torn away.

This decision invalidated the regulations then in force.

In 1938 this court decided M. E. Blatt Co. v. United States, 305 U.S. 267. There, in connection with the execution of a lease, landlord and tenant mutually agreed that each should make certain improvements to the demised premises and that those made by the tenant should become and remain the property of the landlord. The Commissioner valued the improvements as of the date they were made, allowed depreciation thereon to the termination of the leasehold, divided the depreciated value by the number of years the lease had to run, and found the landlord taxable for each year's aliquot portion thereof. His action was sustained by the Court of Claims. The judgment was reversed on the ground that the added value could not be considered rental accruing over the period of the lease; that the facts found by the Court of Claims did not support the conclusion of the Commissioner as to the value to be attributed to the improvements after a use throughout the term of the lease; and that, in the circumstances disclosed, any enhancement in the value of the realty in the tax year was not income realized by the lessor within the Revenue Act.

The circumstances of the instant case differentiate it from the *Blatt* and *Hewitt* cases; but the petitioner's contention that gain was realized when the respondent, through forfeiture of the lease, obtained untrammeled title, possession and control of the premises, with the added increment of value added by the new building, runs counter to the decision in the *Miller* case and to the reasoning in the *Hewitt* case.

The respondent insists that the realty, — a capital asset at the date of the execution of the lease, — remained such throughout the term and after its expiration; that improvements affixed to the soil became part of the realty indistinguishably blended in the capital asset; that such improvements cannot be separately valued or treated as received in exchange for the improvements which were on the land at the date of the execution of the lease; that they are, therefore, in the same category as improvements added by the respondent to his land, or accruals of value due to extraneous and adventitious circumstances. Such added value, it is argued, can be considered capital gain only upon the owner's disposition of the asset. The position is that the economic gain consequent upon the enhanced value of the recaptured asset is not gain derived from capital or realized within the meaning of the Sixteenth Amendment and may not, therefore, be taxed without apportionment.

We hold that the petitioner was right in assessing the gain as realized in 1933.

We might rest our decision upon the narrow issue presented by the terms of the stipulation. It does not appear what kind of a building was erected by the tenant or whether the building was readily removable from the land. It is not stated whether the difference in the value between the building removed and that erected in its place accurately reflects an increase in the value of land and building considered as a single estate in land. On the facts stipulated, without more, we should not be warranted in holding that the presumption of the correctness of the Commissioner's determination has been overborne.

The respondent insists, however, that the stipulation was intended to assert that the sum of $51,434.25 was the measure of the resulting enhancement in value of the real estate at the date of the cancellation of the lease. The petitioner seems not to contest this view. Even upon this assumption we think that gain in the amount named was realized by the respondent in the year of repossession.

The respondent can not successfully contend that the definition of gross income

in [§61(a) of the 1954 Code] is not broad enough to embrace the gain in question. That definition follows closely the Sixteenth Amendment. Essentially the respondent's position is that the Amendment does not permit the taxation of such gain without apportionment amongst the states. He relies upon what was said in Hewitt Realty Co. v. Commissioner, supra, and upon expressions found in the decisions of this court dealing with the taxability of stock dividends to the effect that gain derived from capital must be something of exchangeable value proceeding from property, severed from the capital, however invested or employed, and received by the recipient for his separate use, benefit, and disposal. He emphasizes the necessity that the gain be separate from the capital and separately disposable. These expressions, however, were used to clarify the distinction between an ordinary dividend and a stock dividend. They were meant to show that in the case of a stock dividend, the stockholder's interest in the corporate assets after receipt of the dividend was the same as and inseverable from that which he owned before the dividend was declared. We think they are not controlling here.

While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction. The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization.

Here, as a result of a business transaction, the respondent received back his land with a new building on it, which added an ascertainable amount to its value. It is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as realized taxable gain.

Judgment reversed.

The Chief Justice concurs in the result in view of the terms of the stipulation of facts.

Mr. Justice McReynolds took no part in the decision of this case.

NOTE

1. *Scope of Bruun case.* Would the result have been the same if the original building had not been razed but had been made more valuable by the tenant, either because he had renovated it or because by superior management he had attracted a better class of tenants?

Was the 1933 value of the land and new building combined at least $51,434 greater than the unamortized cost of the land and old building? Or is it possible that, for example, the land had cost $50,000 but was worth only $10,000 in 1933, so that the "net gain of $51,434" represented merely the difference between the value of the new building and the unamortized cost of the old? See Trask v. Hoey, 177 F.2d 940 (2d Cir. 1949).

2. *Statutory modification of Bruun rule.* Constitutional or not, a tax on the value of Mr. Bruun's building may strike unfairly because so much income is telescoped into a single year. The taxpayer could have avoided this problem by constructing the building himself and charging a higher annual rent to recoup its cost. If the Court's decision had been anticipated, the taxpayer might have preferred to renegotiate the rent downward, possibly to substantially less than the property's fair rental value, just to keep the tenant from throwing up the lease. These considerations led Congress in 1942 to enact what is now §109 of the 1954 Code; see also §1019. Note that §109 excludes only such income as the lessor derives upon the *termination* of a lease. Does it apply if the lease expires at the end of the term stipulated by the parties, or only if there is a premature termination (e.g., for nonpayment of rent)?

Note the parenthetical phrase in §109, which is construed by the Regulations in §1.109-1(a); see also §1.61-8(c). How can we determine whether a lessee-constructed improvement constitutes "rent"? In I.T. 4009, 1950-1 C.B. 13, the Internal Revenue Service ruled as follows:

> Under the terms of a 5-year lease of an 80-acre tract of land, the lessee is not required to pay rent, but, in lieu thereof, he agrees to install on the premises a complete irrigation system. The lessee further agrees to clear and level the land, dig ditches, drill a well, install a pump with motor and bring electricity thereto, spread gypsum on the land, plant alfalfa on a certain part thereof, and pay certain taxes, all improvements to become the property of the lessor at the termination of the lease. . . .
>
> In the instant case, the terms of the lease, under which it was agreed that in lieu of rent certain improvements of such a nature as to result in immediate benefit to the lessor when completed or partially completed would be placed upon the land, indicate an intention that the addition of such improvements should be deemed to be rent. Accordingly, it is held that income will result to the lessor to the extent of the fair market value, subject to the lease, of the improvements placed upon the land in any taxable year.

See also Your Health Club, Inc. v. Commissioner, 4 T.C. 385 (1944) (where a lessee was obligated to pay an annual rental of $4250, but was permitted to make certain improvements to the premises, the cost of which might be applied against the rent to the extent of $1500).

INAJA LAND CO. v. COMMISSIONER
9 T.C. 727 (1947)

[In 1928 the taxpayer paid $61,000 for 1236 acres of land on the banks of the Owens River, Mono County, California, together with certain water rights, for use as a private fishing club. The City of Los Angeles constructed a tunnel nearby in 1934 and commenced to divert polluted waters into the Owens River, and this action had a deleterious effect on the fishing on the taxpayer's preserve. In 1939 the City paid taxpayer $50,000 for a release of any liability for this diversion of foreign waters, and for an easement to continue to divert such waters, into the Owens River. In settling its claim against the City, the taxpayer incurred attorneys' fees and costs of $1055.]

LEECH, Judge: The question presented is whether the net amount of $48,945 received by petitioner in the taxable year 1939 under a certain indenture constitutes taxable income under [§61(a)], or is chargeable to capital account. The respondent contends: (a) That the $50,000, less $1,055 expenses incurred, which petitioner received from the city of Los Angeles under the indenture of August 11, 1939, represented compensation for loss of present and future income and consideration for release of many meritorious causes of action against the city, constituting ordinary income; and, (b) since petitioner has failed to allocate such sum between taxable and nontaxable income, it has not sustained its burden of showing error. Petitioner maintains that the language of the indenture and the circumstances leading up to its execution demonstrate that the consideration was paid for the easement granted to the city of Los Angeles and the consequent damage to its property rights; that the loss of past or future profits was not considered or involved; that the character of the easement rendered it impracticable to attempt to apportion a basis to the property affected: and, since the sum received is less than the basis of the entire property, taxation should be postponed until the final disposition of the property. . . .

Upon this record we have concluded that no part of the recovery was paid for loss of profits, but was paid for the conveyance of a right of way and easements.

and for damages to petitioner's land and its property rights as riparian owner. Hence, the respondent's contention has no merit. Capital recoveries in excess of cost do constitute taxable income. Petitioner has made no attempt to allocate a basis to that part of the property covered by the easements. It is conceded that all of petitioner's lands were not affected by the easements conveyed. Petitioner does not contest the rule that, where property is acquired for a lump sum and subsequently disposed of a portion at a time, there must be an allocation of the cost or other basis over the several units and gain or loss computed on the disposition of each part, except where apportionment would be wholly impracticable or impossible. Nathan Blum, 5 T.C. 702, 709. Petitioner argues that it would be impracticable and impossible to apportion a definite basis to the easements here involved, since they could not be described by metes and bounds; that the flow of the water has changed and will change the course of the river; that the extent of the flood was and is not predictable; and that to date the city has not released the full measure of water to which it is entitled. In Strother v. Commissioner, 55 Fed. (2d) 626, the court says:

> . . . A taxpayer . . . should not be charged with gain on pure conjecture unsupported by any foundation of ascertainable fact. See Burnet v. Logan, 283 U.S. 404.

This rule is approved in the recent *Raytheon Prod. Corp.* case [infra p. 86]. Apportionment with reasonable accuracy of the amount received not being possible, and this amount being less than petitioner's cost basis for the property, it can not be determined that petitioner has, in fact, realized gain in any amount. Applying the rule as above set out, no portion of the payment in question should be considered as income, but the full amount must be treated as a return of capital and applied in reduction of petitioner's cost basis. Burnet v. Logan, 283 U.S. 404.

Reviewed by the Court.

Decision will be entered for the petitioner.

NOTE

1. *Effect in later year.* How should the Inaja Land Company report the sale of its entire property, in a later year, for $25,000?

2. *Allocation of taxpayer's cost.* See Regs. §1.61-6, providing that upon the sale of subdivided property, gain or loss shall be computed on the sale of each parcel, notwithstanding the taxpayer has not recouped his entire investment. This rule has been applied in a long line of cases, some of which are cited with approval in Heiner v. Mellon, 304 U.S. 271, 275 n.3 (1938). Suppose the taxpayer paid $10,000 for a tract of land, a block of securities, or a similar aggregate of property, and sells one half for $7500. Has he had a gain under Eisner v. Macomber's definition? What if he can prove that later in the year of sale the remaining property declined in value to $1000?

3. *Constitutional aspects.* On the constitutionality of taxing the gain on an isolated sale of property by a person who is not engaged in the business of selling such property, see Merchant's Loan & Trust Co. v. Smietanka, 255 U.S. 509, 520-521 (1921):

> It is elaborately argued in this case . . . and in other cases since argued, that the word "income" as used in the Sixteenth Amendment and in the Income Tax Act we are considering does not include the gain from capital realized by a single isolated sale of property but that only the profits realized from sales by one engaged in buying and selling as a business — a merchant, a real estate agent, or broker — constitute income which may be taxed.
>
> It is sufficient to say of this contention, that no such distinction was recognized in the Civil War Income Tax Act . . . or in the Act of 1894 . . . , declared unconstitutional on an unrelated ground; that it was not recognized in determining income

under the Excise Tax Act of 1909 . . . ; that it is not to be found, in terms, in any of the income tax provisions of the Internal Revenue Acts of 1913, 1916, 1917 or 1919; that the definition of the word "income" as used in the Sixteenth Amendment, which has been developed by this court, does not recognize any such distinction; that in department practice, for now seven years, such a rule has not been applied; and that there is no essential difference in the nature of the transaction or in the relation of the profit to the capital involved, whether the sale or conversion be a single, isolated transaction or one of many. The interesting and ingenious argument, which is earnestly pressed upon us, that this distinction is so fundamental and obvious that it must be assumed to be a part of the "general understanding" of the meaning of the word "income" fails to convince us that a construction should be adopted which would, in a large measure, defeat the purpose of the Amendment.

SECTION D. RECOVERY OF CAPITAL

STANTON v. BALTIC MINING CO.

240 U.S. 103 (1916)

[Under the 1913 income tax law, the taxpayer (a mining corporation) was taxed on its gross receipts less business expenses and losses and less 5 per cent of the gross value of its production of ore. It attacked the constitutionality of the law on a number of grounds, only one of which is involved in the extract that follows. This ground was that the 5 per cent allowance for depletion of its ore body was inadequate, since the ore in question had cost it more than the depletion allowance. This contention can be better understood if illustrated. Assume that a mining corporation pays $1,000,000 for a mine containing 1,000,000 tons of recoverable ore, and that the land will be totally worthless when this deposit has been mined. Assume further that in a given year 100,000 tons are mined and sold for $1,500,000. Under the 1913 law the taxpayer could deduct 5 per cent of the sales price, or $75,000, for depletion, and the balance (less other expenses) would be taxable income. But, argued the taxpayer, the 100,000 tons of ore mined actually cost $100,000, since it paid $1,000,000 for a deposit of 1,000,000 tons, and therefore the depletion allowance is inadequate. (It should be noted that percentage depletion might exceed, instead of falling short of, any particular taxpayer's cost for his product. The importance of this possibility is seen infra page 317.)]

MR. CHIEF JUSTICE WHITE delivered the opinion of the Court.

. . . The contention is that as the tax here imposed is not on the net product, but in a sense somewhat equivalent to a tax on the gross product of the working of the mine by the corporation, therefore the tax is not within the purview of the 16th Amendment, and consequently it must be treated as a direct tax on property because of its ownership, and as such void for want of apportionment. But, aside from the obvious error of the proposition, intrinsically considered, it manifestly disregards the fact that by previous ruling* it was settled that the provisions of the 16th Amendment conferred no new power of taxation, but simply prohibited the previous complete and plenary power of income taxation possessed by Congress from the beginning from being taken out of the category of indirect taxation to which it inherently belonged, and being placed in the category of direct taxation subject to apportionment by a consideration of the sources from which the income was derived, — that is, by testing the tax not by what it was, a tax on income, but by a mistaken theory deduced from the origin or source of the income taxed. Mark, of course, in saying this we are not here considering a

* Brushaber v. Union Pacific R. Co., 240 U.S. 1 (1961). — ED.

tax not within the provisions of the 16th Amendment, that is, one in which the regulation of apportionment or the rule of uniformity is wholly negligible because the tax is one entirely beyond the scope of the taxing power of Congress, and where consequently no authority to impose a burden, either direct or indirect, exists. In other words, we are here dealing solely with the restriction imposed by the 16th Amendment on the right to resort to the source whence an income is derived in a case where there is power to tax for the purpose of taking the income tax out of the class of indirect, to which it generically belongs, and putting it in the class of direct, to which it would not otherwise belong, in order to subject it to the regulation of apportionment. But it is said that although this be undoubtedly true as a general rule, the peculiarity of mining property and the exhaustion of the ore body which must result from working the mine cause the tax in a case like this, where an inadequate allowance by way of deduction is made for the exhaustion of the ore body, to be in the nature of things a tax on property because of its ownership, and therefore subject to apportionment. Not to so hold, it is urged, is as to mining property but to say that mere form controls, thus rendering in substance the command of the Constitution that taxation directly on property because of its ownership be apportioned, wholly illusory or futile. But this merely asserts a right to take the taxation of mining corporations out of the rule established by the 16th Amendment when there is no authority for so doing. It moreover rests upon the wholly fallacious assumption that, looked at from the point of view of substance, a tax on the product of a mine is necessarily in its essence and nature in every case a direct tax on property because of its ownership, unless adequate allowance be made for the exhaustion of the ore body to result from working the mine. We say wholly fallacious assumption because, independently of the effect of the operation of the 16th Amendment, it was settled in Stratton's Independence v. Howbert, 231 U.S. 399, that such tax is not a tax upon property as such because of its ownership, but a true excise levied on the results of the business of carrying on mining operations.

As it follows from what we have said that the contentions are in substance and effect controlled by the *Brushaber* case, and, in so far as this may not be the case, are without merit, it results that, for the reasons stated in the opinion in that case and those expressed in this, the judgment must be and it is affirmed.

MR. JUSTICE MCREYNOLDS took no part in the consideration and decision of this case.

NOTE

Implications of Baltic Mining case. What if by the time the mine has been exhausted the taxpayer has been taxed on more than the difference between its gross receipts and the sum of operating expenses plus the cost of the mine? Would the Court's reasoning sustain a federal "excise" tax on the receipt by taxpayer Macomber of her stock dividends? See Magill, Taxable Income 355-373 (rev. ed. 1945). Does this case mean that taxpayers engaged in selling property need not be allowed a deduction for the cost of the property?

Doyle v. Mitchell Bros. Co., 247 U.S. 179 (1918), involved a corporate taxpayer that sold, after the 1909 corporate income tax was enacted, timber that it had purchased before 1909. The taxpayer sought to offset against the gross receipts from the timber its *value* as of the beginning of 1909, and the Treasury took the position that only its *cost* could be used in computing taxable income. The Court held for the taxpayer, saying:

> There is no express provision that even allows a merchant to deduct the cost of the goods that he sells. Yet it is plain, we think, that by the true intent and meaning of the act the entire proceeds of a mere conversion of capital assets were not to be treated as income. . . . In order to determine whether there has been gain or loss, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that

existed at the commencement of the period under consideration. . . . It may be observed that it is a mere question of methods, not affecting the result, whether the amount necessary to be withdrawn in order to preserve capital intact should be deducted from gross receipts in the process of ascertaining gross income, or should be deducted from gross income in the form of a depreciation account in the process of determining net income. In either case the object is to distinguish capital previously existing from income taxable under the act. There is only a superficial analogy between this case and the case of an allowance claimed for depreciation of a mining property through the removal of minerals, since we have held that owing to the peculiar nature of mining property its partial exhaustion attributable to the removal of ores cannot be regarded as depreciation within the meaning of the act. [247 U.S. at 184-188.]

See Magill, Taxable Income 347-368 (rev. ed. 1945), discussing the *Stanton* and *Mitchell Bros. Co.* cases, which states (p. 351):

> . . . the *Stanton* case is not a sufficient basis for the generality that gross *receipts* (as distinguished from gross income) can be taxed as income under the [Sixteenth] amendment. Rather, the *Stanton* case and its successors are authority for the proposition that, in view of the fact that the extent of a mineral deposit is an unknown quantity, Congress may impose limitations on the depletion deduction which it could not place upon the deduction for the cost of other goods sold. Stated in another way, the theory may be that, as in Great Britain, the proceeds of the output of a mine, less the cost of production, are income, and because of inherent uncertainties [in calculating the cost of the ore mined] no direct allowance for depletion need be made, any loss on account of the working of the mine being allowed if, and when, the mine is sold.

See also Spreckels Sugar Refining Co. v. McClain, 192 U.S. 397 (1904), where the Supreme Court upheld as an excise, against the contention that it was an unapportioned direct tax, a tax on the gross annual receipts of any person or corporation carrying on the business of refining sugar.

SULLENGER v. COMMISSIONER

11 T.C. 1076 (1948)

MURDOCK, Judge: . . .

The petitioner paid to wholesale meat packing firms during the taxable years, for meats purchased from them, amounts in excess of the O.P.A. [Office of Price Administration, a World War II agency] prices in effect at the time of the purchases. The petitioner then sold the meat and the income from those sales is being taxed. The Commissioner, in determining the deficiencies, failed to recognize the excess over O.P.A. prices as cost of goods sold.

The respondent argues that the amounts paid in excess of the O.P.A. prices were "not truly a part of cost of goods sold" but were "in reality nothing but a 'bribe' to the various packing firms or amounts paid to them illegally to induce them to sell the goods to petitioner at the ceiling price." He then argues that the amounts must be considered from the standpoint of deductions, deductions are a matter of grace and not of right, to allow these amounts as deductions would be contrary to public policy, and, therefore, the determination of the Commissioner must be affirmed.

The trouble with his argument is that its major premise is unsound. The amounts in question were actually, as the stipulation shows, a part of the cost of goods sold and are not being claimed by this petitioner as a deduction under [§162]. [Section 162] makes no provision for the cost of goods sold, but the Commissioner has always recognized, as indeed he must to stay within the Constitution, that the cost of goods sold must be deducted from gross receipts

in order to arrive at gross income.* No more than gross income can be subjected to income tax upon any theory. The income from a business which is wholly illegal was held subject to income tax in United States v. Sullivan, 274 U.S. 259. Nevertheless, it was necessary to determine what that income was, and the cost of an illegal purchase of liquor was subtracted from proceeds of the illegal sale of the liquor in order to arrive at the gain from the illegal transactions which were subjected to income tax in that case. This is not a case of penalties provided for violation of the O.P.A. regulations. See the Emergency Price Control Act of 1942 (Title 50, App. U.S.C.A., sec. 901 et seq.). No authority has been cited for denying to this taxpayer the cost of goods sold in computing his profit, which profit alone is gross income for income tax purposes. It is unnecessary to discuss cases involving deductions, since this case does not involve any deduction. The point in controversy is decided for the petitioners.

Reviewed by the Court.

Decisions will be entered under Rule 50.

DISNEY, J., dissenting.

I can not agree with the conclusion that the cost of goods above the ceiling price set by law should be subtracted from gross receipts in order to determine gross income. No such question was considered or conclusion reached in United States v. Sullivan, 274 U.S. 259, relied on in the majority opinion. There only two points were considered: (a) Is the income from illegal business taxable? (b) Did the Fifth Amendment protect the taxpayer from making a return? As indication of how narrow the Court's field of examination was, we quote the last paragraph:

> It is urged that if a return were made the defendant would be entitled to deduct illegal expenses such as bribery. This by no means follows, but it will be time enough to consider the question when a taxpayer has the temerity to raise it.

This problem has received attention in I.T. 3724 [where] precisely the instant situation was involved, and amounts paid in "black market" operations in excess of ceiling prices were held not allowable either as a part of cost of goods sold, or as business expense deduction in computing Federal income tax. The I.T. quotes the Emergency Price Control Act of 1942, in pertinent part, as follows: "It shall be unlawful, . . . to sell or deliver any commodity, or in the course of trade or business to buy or receive any commodity, . . . in violation of any . . . price schedule . . ." set by the law. [1945 C.B. 57.] Thus, both the buying and selling by the petitioner were illegal, if above ceiling prices. Though Steinberg v. United States, 14 Fed. (2d) 564, holds that ordinary and necessary expenses may be deducted in arriving at profits of an illegal business, a long line of cases establishes that "ordinary and necessary" does not include illegal expenses contrary to public policy. Such cases are assembled in I.T. 3724, supra; and there it is concluded, referring to payments in excess of ceiling prices, that "The excess payments are not legitimately to be classified as a part of the cost of goods sold, and public policy decrees that no tax advantage may be derived from such expenditures." I am unable to distinguish the expenditure here involved, so far as here concerned, from expenses found, on grounds of public policy, not to be ordinary and necessary; and any suggestion that the petitioners' capital went into the goods purchased is subject to the same conclusion, that public policy forbids the allowance. The majority view stultifies the law. In effect it means that, though for purposes of preventing inflation the O.P.A. law is effective, the law of income taxation can not recognize it, regardless of the sound public policy involved.

* See Regs. §1.61-3(a). — ED.

The law of income taxation is thus made to uphold the inflation the O.P.A. law seeks to prevent. Had the petitioner, violating the O.P.A. law in purchasing above price ceilings, taken, on the contrary, a loss, it would not be allowable. Lawrence A. Wagner, 30 B.T.A. 1099, and cases following it. On the broad question of public policy here involved, I think there is no sound reason to distinguish the present situation from those above covered. The definition of income is broad and inclusive, therefore illegality of business can not serve as a shield; but it does not follow that every expense incurred, however illegal in its nature, may serve to diminish the receipts. Would expenses of bribery be allowed because an integral part of an illicit business? If not, why exclude from the same category an amount expended which is equally illegal? The amount above ceiling price is affirmatively and positively illegally expended, under the O.P.A. law. It was not necessary, in order to stay in business, to pay the prices in excess of the ceiling set (under any application of Commissioner v. Heininger, 320 U.S. 467), so far as I see indicated in this case. I think the law here administered must be consistent with the statute passed against inflation, and not contribute thereto despite that law. The whole income tax set-up and administration is a creature of constitution and law. Why an expenditure in contravention of law, and of public policy, should be permitted subtraction and thus affect such taxation, is difficult to understand. Is the law of income tax thus to serve as an exception to the O.P.A. law and its objectives? I think that purchases, like other expenses, to secure effect in reducing what would otherwise be taxed, must be within the law. I respectfully dissent.

NOTE

1. *Result in other cases.* In a number of other cases, the same result was reached on the ground that Congress did not *intend* to disallow such over-ceiling payments in calculating taxable income. Commissioner v. Weisman, 197 F.2d 221 (1st Cir. 1952); and cases cited in I.T. 4104, 1952-2 C.B. 71, where the Internal Revenue Service announced its acquiescence in the *Sullenger* case. Chief Judge Magruder, concurring in the *Weisman* case, said:

> But I hope the court's opinion will not give the impression that there is any serious doubt of the constitutional power of Congress to exclude from the offset so much of the cost of the goods sold as represented payment by the taxpayer in excess of the applicable ceiling price.
>
> It may be that a merchant's gross receipts from sales of a commodity represent a return of capital, and not gross income, at least to the extent of the cost to the merchant of the goods sold. In this view, a tax by Congress on the merchant's gross receipts, as such, would not be a tax on income, sustainable under the Sixteenth Amendment. The question then would be whether such a tax fell within the general taxing power of Congress conferred by Article I, §8, of the Constitution, or whether it would be deemed a "direct" tax which had to be laid in proportion to the population, as provided in Article I, §9.

Judge Magruder went on to argue that as a penalty for violating the price control program, Congress could have provided for the disallowance of over-ceiling payments for goods sold:

> It seems to me clear that Congress would have constitutional power to impose such a sanction, to be applied in the administration of the tax laws, whether or not Congress would have power to impose a general tax on gross receipts, applicable to the law-abiding as well as to law violators. [197 F.2d at 224-226.]

See the *Spreckels Sugar Refining Co.* case, supra page 72.

2. *Disallowance by statute.* The World War II Price Control Act authorized the President to prescribe the extent to which over-ceiling *wage* and *salary* payments should

be disregarded "in determining the costs or expenses of any employer," and pursuant to this authorization the President issued an Executive Order providing that such payments should not be allowed as deductions under the Internal Revenue Code. In Weather-Seal Mfg. Co. v. Commissioner, 16 T.C. 1312 (1951), aff'd per curiam, 199 F.2d 376 (6th Cir. 1952), this disallowance was held to be constitutional, despite the fact that the disallowed wage payments were, pursuant to customary accounting practice, part of the taxpayer's "cost of goods sold." See also N. A. Woodworth Co. v. Kavanaugh, 102 F. Supp. 9 (E.D. Mich. 1952), aff'd per curiam, 202 F.2d 154 (6th Cir. 1953).

The Defense Production Act of 1950 (unlike its World War II counterpart, under which the *Sullenger* case was decided) expressly authorized a disallowance of over-ceiling payments in calculating gain on the sale of property. I.T. 4105, 1952-2 C.B. 93; see Pedone v. United States, 151 F. Supp. 288 (Ct. Cl. 1957) (divided court).

3. *Illegal payments as deductible business expenses.* As to whether illegal payments may be deducted as "ordinary and necessary" business expenses, see pages 279-283 infra.

PERRY v. UNITED STATES

160 F. Supp. 270 (Ct. Cl. 1958)

WHITAKER, Judge.

Plaintiffs, who have filed a joint income tax return for the calendar year 1953, sue to recover taxes paid by them for that year in the amount of $8,287.26, plus interest as provided by law. The issue presented is whether an income tax may be imposed upon the corpus of a charitable trust that has been returned to the sole settlor when the donees thereof have refused to comply with the terms of the gift.

Plaintiff William F. Perry in 1944 created a trust for the benefit of the Town of Fitzwilliam, New Hampshire. The corpus was to be used for the construction of an addition to the Public Library and for no other purpose. The town decided that it did not desire to build the addition to the library, and the corpus of the trust was returned to the settlor in 1953.

The Commissioner of Internal Revenue required plaintiffs to include in their income tax return for 1953 the amount returned to them in that year. Plaintiffs say this is improper, because what they received was a return of capital, and not income. The defendant says it was proper because plaintiffs, in the years they made contributions to the trust, deducted the amounts contributed from their income, and thus received a tax benefit in those years.

There can be no doubt that what the taxpayer received from the town in 1953 was a return of capital and not income, except for the accumulations of interest and dividends on the corpus. The taxpayer admits he is required to include these accumulations in his income.

The taxpayer does not admit that he is required to account for the appreciation in value of the securities, and we do not think he is. He gave the securities to the town for a specific purpose. When the securities were returned, because the town did not desire them for this purpose, it was as if they had remained in the taxpayer's possession all the time, and, hence, he was not required to account for the appreciation in value until he disposed of them.

As stated, the return to the taxpayer of the property he had tried to give away cannot possibly be considered as income — he merely got back his own property. It cannot possibly be considered as income, except on the ground that he had deducted from his income the amount contributed in each year, thus reducing his taxes. In such cases the courts have heretofore required the inclusion of an item recovered, where a deduction had been taken for it in a prior year.

The only rational basis for such decisions is that it would be inequitable for the taxpayer to reduce his taxes for prior years on account of the contributions,

and not to pay taxes on them when he got them back. This is the so-called tax benefit rule. It is a rule enunciated by the courts, and not by Congress, and is based altogether on equitable considerations. But the Supreme Court, in the case of Lewyt Corp. v. Commissioner, 349 U.S. 237, 240, had this to say of equitable considerations in the administration of tax law:

> But the rule that general equitable considerations do not control the measure of deductions or tax benefits cuts both ways. It is as applicable to the Government as to the taxpayer. Congress may be strict or lavish in its allowance of deductions or tax benefits. The formula it writes may be arbitrary and harsh in its applications. But where the benefit claimed by the taxpayer is fairly within the statutory language and the construction sought is in harmony with the statute as an organic whole, the benefits will not be withheld from the taxpayer though they represent an unexpected windfall. . . .

In other words, the Supreme Court said that equitable considerations have no place in the laws of taxation. The tax benefit rule is based upon equitable considerations, and if we are to take the statement in Lewyt Corp. v. Commissioner, supra, at its face value, we must hold that the amounts received in 1953 are not to be included in gross income merely because the taxpayer had received a tax benefit on account of them in prior years.

We must say, however, that the tax benefit rule seems well entrenched in judicial decision. The Supreme Court impliedly recognized it in Dobson v. Commissioner [infra p. 862], and had done so many times before.

The only Congressional sanction for the tax benefit rule is [§111], which prohibits the inclusion within income of a subsequent year of all amounts recovered as to which the taxpayer had received no tax benefit as the result of a deduction in a prior year. This was limited, however, to the recovery of bad debts, and taxes and delinquency amounts.

The present case does not come within the provisions of that statute. The Commissioner of Internal Revenue, however, after the enactment of [§111] made the section applicable to transactions other than bad debts and taxes. In [Regs. §1.111-1(a)] it was provided that tax benefit principles should apply to "other losses, expenditures, and accruals made the basis for deductions."

If, therefore, we should hold that the amounts received in 1953 were not includable in gross income at all, we would be going contrary to prior judicial decisions, and to the express provisions of the Treasury Regulations. Therefore, bowing to the weight of judicial precedents, and in the face of the language in the *Lewyt* case, supra, we feel compelled to hold that we must take into account the tax benefit received by the taxpayers in prior years.

By this we mean that in computing income for 1953, the taxpayers should exclude from their income the amount of the corpus returned to them in that year, but they should add to the tax thus computed on their 1953 income the amount by which their taxes in prior years had been decreased on account of the deductions made for contributions to this trust fund. So computed, the Government would recoup the taxes escaped in the prior year on account of the deduction. It would be inequitable to require plaintiffs to include in their income for 1953 the aggregate of the deductions claimed in prior years, because of the fact that the rates of taxation vary greatly from year to year, and because the inclusion in one year of all the deductions taken in several years would probably put the taxpayer in a higher tax bracket.

In computing the gain on the stock sold by the settlor shortly after it was returned to him, original cost should be used as a basis.

Plaintiffs are entitled to recover, including interest as provided by law, and judgment is entered to that effect. . . .

JONES, Chief Judge, and LITTLETON, Judge, concur.

MADDEN, Judge (dissenting).

When the plaintiff William F. Perry conveyed the property in question to the town, he inserted a condition that if the property was not used to finance an addition to the library, it should be returned to him. He thus retained an interest in the property, of a highly contingent nature, an interest not at all likely to expand into complete ownership. But his contingent interest did expand into complete ownership.

If one sells a piece of land, and is paid for it, but puts a condition in the deed that if liquor is sold on the premises he is to get the land back, he has a contingent interest comparable to that of the grantor plaintiff in the instant case. If the condition happens and he gets the land back, I suppose there are no immediate income tax consequences. If he later sells it, I suppose his basis would be zero, because he was once paid for the land, and his capital gain or loss was computed at that time.

The factor in the instant case that produces possible tax consequences is that the conveyance subject to the condition subsequent was a conveyance to charity, and therefore was deductible, and was deducted from otherwise taxable income in the year in which the conveyance was made.

The plaintiff urges that the reconveyance from the town to him was a gift, and therefore expressly tax free to him as recipient, under [§102(a)]. This would present the unusual situation of a gift *from a charity,* in contrast to the usual one of a gift to a charity. The interest which the plaintiff reserved in the property when he conveyed it to the town was the reason and consideration for the town's reconveyance to him, and the transaction was not a gift.

What we have, then, is the unanticipated recovery by a former owner of property of that property after he has given it up for lost. The plaintiff was in a situation comparable to that of the person who has had to pay taxes and hopes that he may get them back later by litigation, or the one who has given up all real hope of collecting a debt owed to him. In the latter case, the income tax law allows a deduction from income for the taxes paid, and for the bad debt. In these latter situations, if the taxpayer recovered his taxes or collected his bad debt in a later year, the administrative authorities and the courts, without the help of any statute, required him to pay income tax upon his recovery. Of course, one does not ordinarily acquire taxable income by collecting a debt, or by a refund of taxes which he never should have had to pay. The reason that the money was regarded as taxable in the special cases referred to was that, once having used the taxes paid or the bad debt as a tax deduction, the prospect of recovery was, *for income tax purposes,* written off, though as a legal claim it still existed. Having been written off, the later realization of the claim was, *again for tax purposes,* like a windfall to the taxpayer, and within the broad definition of taxable income. See Commissioner v. Glenshaw Glass Co., 348 U.S. 426; Park & Tilford Distillers Corp. v. United States, 107 F. Supp. 941.

Section [111] was not the origin of the doctrine of taxability in the situations described above. It was rather a limitation upon the existing judge-made rule of taxability, limiting the amount of the recovery which could be taxed to the amount which had actually been used as a deduction in the prior year. Section [111] applies only to the later recovery of bad debts, taxes, and delinquency amounts.

The doctrine which existed prior to [§111] would certainly have been applicable to other situations which fell within the reason of the doctrine. For example, if one had taken a deduction for property stolen from him, and had in a later year recovered the stolen property, he would, I should suppose, have been

taxable upon its value. He owned it all the time for most legal purposes, but for income tax purposes he had written it off. I think the same is true of the unique situation of the plaintiff.

From what I have said, it would follow that the law prior to the enactment of [§111] would be applicable to situations other than those covered by that section. There is no indication that Congress intended to change the law except to put the limitation noted above upon it, for the benefit of the taxpayer in the kind of cases that most frequently arise. We need not decide whether the limitation would be applicable in the instant case, since the plaintiff received full tax deductions for the charitable gifts in the years in which they were made.

If the foregoing analysis is correct, the property reconveyed to the plaintiff was taxable income. I think it should be treated as such. The comparable recoveries, in the cases of bad debts and refunds of taxes, were so treated under the judge-made law which preceded the enactment of [§111] and are so treated under that section. If Congress, in enacting [§111] had chosen to provide in it for the meticulous recomputation which the court's opinion requires, that would have been a reason for the court's doing so in this analogous case not covered by the statute. Since Congress did not regard such a recomputation as necessary to do equity in the numerous cases covered by the statute, I think the plaintiff's unusual situation should not be accorded a treatment different from that accorded other taxpayers whose claims to equitable treatment are exactly equivalent to those of the plaintiff.

LARAMORE, Judge, joins in the foregoing dissenting opinion.

NOTE

1. *Recovery of amount previously deducted.* If Jones lends his automobile or a sum of money to Smith, we would not expect Jones to realize taxable income on getting his car or his money back; and one might assume that the recovery of an amount paid on account of an erroneous grocery bill or an unconstitutional tax would be equally excluded from gross income. It has long been established, however, that the collection of a loan that was written off as a bad debt, or the recovery of a sum that was deducted as a tax or business expense, may produce taxable income; estoppel (arising from the taxpayer's representation of the debt as uncollectible, or the payment as actually due) is the usual explanation of this principle, though sometimes other theories are advanced (e.g., that the recovery takes the place of the increase in taxable income that would have been reported in the earlier year had it not been for the deduction). See Plumb, The Tax Benefit Rule Today, 57 Harv. L. Rev. 129, 131 (1943), which cites the relevant cases and authorities. Less clear is the extent of the taxpayer's obligation to report recoveries of items that could have been (but were not) deducted and items that were deducted erroneously.

2. *The "tax benefit" rule.* The principle that the recovery of an amount previously deducted is includible in income is sometimes applied only if the deduction served to reduce the taxpayer's income tax (either directly, or by increasing a loss that was of tax benefit in another year). Both the basic principle and the "tax benefit" variation are of judicial and administrative rather than statutory origin; but in 1942 Congress enacted the predecessor of §111, providing that income attributable to the recovery of a bad debt, prior tax, or "delinquency amount" (interest paid for late filing of a tax return, etc.) may be excluded from gross income to the extent that the prior deduction was of no tax benefit. (Section 111 unmistakably implies, even though it does not explicitly provide, that the recovery *is* taxable to the extent that the deduction *was* of tax benefit, thus endorsing the "basic principle" described above.) In *Perry,* the court states that §111 does not preempt the "tax benefit" field, and Regs. §1.111-1(a) agrees with this conclusion; see also California & Hawaiian Sugar Refining Corp. v. United States, 311 F.2d 235 (Ct. Cl. 1962) (recovery of unconstitutional taxes held a return of capital to a taxpayer that was a tax-exempt co-op when the taxes were paid and hence not entitled to deduct them, though it

was a taxable organization when the recovery was received). When the taxpayer is able to "use" the full amount of a deduction to derive a tax benefit, however, the "basic principle" has usually required the recovery to be included in income even if the increase in tax thus produced exceeds the reduction in the earlier year's tax. The *Perry* case is idiosyncratic in excluding the recovery from income but increasing the tax for the year of recovery by the amount of the saving enjoyed in the earlier year, and the Internal Revenue Service has announced its non-acquiescence. Rev. Rul. 59-141, 1959-1 C.B. 17.

This subject is examined more fully infra pages 867-869.

SECTION E. RECOVERIES FOR PERSONAL AND BUSINESS INJURIES

SOL. OP. 132
I-1 C.B. 92 (1922)

The question presented is whether the following receipts constitute income within the meaning of the sixteenth amendment and the statutes enacted thereunder: (1) Damages for alienation of affections; (2) damages for slander or libel of personal character; and (3) money received by a parent in consideration of the surrender of his right to the custody of his minor child.

All of these items relate to personal or family rights, not property rights, and accordingly may be treated together. Nor is there a material distinction between payment under an agreement of the parties and payment pursuant to a judgment of a court.

It is held in Solicitor's Memorandum 957 that money recovered as damages in libel proceedings is subject to income tax, and in Solicitor's Memorandum 1384, that damages for alienation of a wife's affections are not exempt from income tax under [§104(a)(2), relating to "damages received . . . on account of personal injuries or sickness"]. Both of these rulings, however, were made prior to the decision of the Supreme Court in Eisner v. Macomber (252 U.S. 189). Solicitor's Memorandum 1384 correctly held that the exemption contained in [§104(a)(2)] does not include damages for alienation of affections, but the question is really more fundamental, namely, whether such damages received by a lawyer for libel of his professional reputation constitute income. Business libel may be distinguished from ordinary defamation of character and is not here under consideration. The ruling in Solicitor's Memorandum 957, however, was not limited but apparently applied to libel generally.

In Stratton's Independence v. Howbert (231 U.S. 399) and in Eisner v. Macomber (252 U.S. 189, 207), the Supreme Court defined income as "the gain derived from capital, from labor, or from both combined. . . ." In other words, without gain of some sort no income within the meaning of the sixteenth amendment can be said to be realized.

In the light of these decisions of the Supreme Court it must be held that there is no gain, and therefore no income, derived from the receipt of damages for alienation of affections or defamation of personal character. In either case the right invaded is a personal right and is in no way transferable. While a jury endeavors roughly to compute the amount of damage inflicted, in the very nature of things there can be no correct estimate of the money value of the invaded rights. The rights on the one hand and the money on the other are incomparable things which can not be placed on opposite sides of an equation. If an individual is possessed of a personal right that is not assignable and not susceptible of any appraisal in relation to market values, and thereafter receives either damages or

payment in compromise for an invasion of that right, it can not be held that he thereby derives any gain or profit. It is clear, therefore, that the Government can not tax him on any portion of the sum received. This also applies to money received in consideration of the surrender of the custody of a minor child. Holding otherwise would be equivalent to treating as chattels the wife whose affections were alienated and the child whose custody was surrendered.

In the cases cited above, in Lynch v. Turrish (247 U.S. 221), and in other cases, the Supreme Court has repeatedly held that gross income does not include everything that comes in. In Gould v. Gould (245 U.S. 151) it was held that alimony is not income.* Before the enactment of [1954 Code, §104(a)(2)], which specifically exempted from gross income damages for personal injuries, it was held that damages for personal injuries due to accident do not constitute income. T.D. 2747 (not published in Bulletin service). Much less should damages for alienation of affections or defamation of personal character be held to constitute income. Slander or libel affecting business reputation or property rights, however, are not considered in this opinion.

I am of the opinion, therefore, that money received, whether under agreement of the parties or pursuant to judgment of a court, on account of damages for alienation of affections or defamation of personal character or in consideration of the surrender of the custody of a minor child, does not constitute income within the meaning of the sixteenth amendment and the statutes enacted thereunder.

Solicitor's Memorandum 957 is modified to accord with this opinion, and Solicitor's Memorandum 1384 is revoked.

NOTE

1. *Breach of promise to marry.* In 1923, the Internal Revenue Service announced that damages received for breach of a promise to marry were not taxable, on the ground that "a promise to marry is a personal right not susceptible of any appraisal in relation to market values and that damages or payment in compromise of the invasion of such right does not constitute taxable income." I.T. 1804, II-2 C.B. 61, 62 (1923).† Later this ruling

* Periodic payments of alimony are now ordinarily taxable to the ex-wife, under a statutory provision (§71) that is examined infra page 178 et seq. — Ed.

† See Ruslander, Humor in Income Tax Cases, 16 U. of Pitt. L. Rev. 223 (1955):

"In 1920, a taxpayer was facing a threatened criminal prosecution for having filed a false federal income tax return. He had not included in his income $30,000 received in the year at issue as damages for alienation of his wife's affections. He loved his wife and their one child, a son, and after his case was settled he went to pieces, lost his job, took to drink and forgot all about income taxes. When the revenue agent caught up with him he had no money to pay the tax claimed. He was told that he could be sent to jail for fraud because he had concealed receipt of this $30,000.

"Taxpayer and his counsel (the author) went to Washington to argue the case before a committee of three taxing officials representing the Commissioner of Internal Revenue. This was before Congress had created the Board of Tax Appeals, now The Tax Court of the United States. The presiding member of this committee was a young unmarried woman. The other two members were men. The history of the case was gone into, the taxpayer was present in person and was exhibited to the best advantage possible. Counsel argued that they came from the great Commonwealth of Pennsylvania, a state where a married man had a property right in his wife known as the right of 'consortium,' and if a married man was wrongfully deprived of this right and received damages to compensate him for his loss, the money received did not, as limited by the Sixteenth Amendment to the Constitution of the United States, constitute '. . . incomes, from whatever source derived. . . .' Therefore, that $30,000 at issue was not subject to an income tax as recognized by the United States Supreme Court. At the conclusion of this argument the lady of the committee asked if it were claimed that in this day and age a married man, even in Pennsylvania, had a property right in his wife. After being assured that such was the fact she said to the counsel, 'Young man, so far as I am concerned, you are talking a dead language.'

"The committee decided adversely to the taxpayer, but was reversed on appeal."

was revoked. I.T. 2170, IV-1 C.B. 28 (1925). The revocation was apparently based on a distinction between payments for relinquishing contract rights and payments to redress torts:

> As a general rule, rights acquired . . . through the exercise of one's physical or mental faculties, when converted into cash or its equivalent, constitute income to the recipient to the full amount received. . . .
>
> The situation presented by Solicitor's Opinion 132 is quite different. The payment involved was attributable to a tort. A personal injury was inflicted, an inherent right was invaded, a right in rem given by the law against the whole world. The holding is merely that payments to compensate a taxpayer for that of which he has been deprived by the invasion of such an inherent right do not constitute "gain" to him, and therefore no income results. . . .
>
> Solicitor's Opinion 132 is distinguishable in that the damages received by the taxpayer in that case were on account of a past injury suffered through an invasion of an inherent, personal right, a right which is granted by law to all persons in similar circumstances, as distinguished from one which arises out of a contract of which the benefits are due, in the last analysis, to the exercise of the mental faculties. [S.M. 2042, IV-1 C.B. 26, 27-28 (1925).]

In McDonald v. Commissioner, 9 B.T.A. 1340 (1928), damages for breach of contract to marry were held non-taxable on the authority of the *Hawkins* case, infra page 82.

2. *Right to privacy.* In Ehrlich v. Higgins, 52 F. Supp. 805 (S.D.N.Y. 1943), the widow of Paul Ehrlich (the discoverer of "Salvarsan") asserted that $42,500 paid to her by Warner Bros. Pictures, Inc., which was producing a motion picture based on her husband's life, was not taxable because the payment was intended as damages for invasion of her right of privacy. The court found that the payment was made primarily for the use of certain letters, notes, and similar material, and not as compensation for an invasion of privacy. But the court went on (52 F. Supp. at 808-809) to make this comment on Solicitor's Opinion 132:

> It seems probable that if a woman were paid a consideration in monthly payments for a voluntary release of her fiancé from a promise to marry, she would be paid for giving up a legal right and, therefore, the foundation would be the same as in all other contracts.
>
> The only suggestion in the literature on the subject that a contrary result might be reached appears in an opinion of the Solicitor of Internal Revenue (Cumulative Bulletin I-1, 92), where it is said that money received by a parent in consideration of the surrender of his right to the custody of his minor child stands on the same basis as damages for alienation of affections and damages for personal libel or slander. This notion permits no distinction between damages for wrongs committed and payments for giving up any legal right. The parent could contract for the labor of the child and the payments would not be exempt. The writer of the opinion arrived at the conclusion by the emotional avenue, saying that: "Holding otherwise would be equivalent to treating as chattels the wife whose affections were alienated and the child whose custody was surrendered." The real difference between the two cases is that in one there is consummated damage to a personal right which is compensated, and in the other a simple contract, whereby a right presently possessed is resigned for a future period for money.
>
> Much more accurate are the cases which recognize the fact that contractual surrender of any legal right for stated payments produces income to the recipient. So it has been held that payments not to work for another or compete in business are taxable as income. So, also, the sales of good will, together with tangible assets of a business are subject to the laws regulating taxes.
>
> If the contrary principle were recognized, there would be suits for refunds by each of the actresses in Hollywood upon the ground that, although each is paid a salary for personal services in the production of films, the real value which the producer obtains from the contract is the right to produce before the public the representation

so made, and that the payments are really damages in prospect for the violation of the right of personal privacy. The revenue laws do not contain any such loophole.

In Starrels v. Commissioner, 304 F.2d 574 (9th Cir. 1962), the taxpayer argued that an amount received by her from a motion picture producer for her consent to being portrayed in a movie based on her father's life was paid for an invasion of privacy and was excluded from gross income by §104(a)(2) (damages for personal injury, infra p. 154). The argument was rejected on the ground that no actual invasion of privacy occurred, and the court suggested also that §104(a)(2) would not apply, in any event, to payments received in advance of, and for consenting to, such an injury.

3. *Indemnification for loss of human rights.* In Rev. Rul. 55-132, 1955-1 C.B. 213, the Internal Revenue Service ruled that payments made by the United States under the War Claims Act to a taxpayer who had been a prisoner of war, because the enemy government had violated its obligation under the Geneva Convention to provide humane treatment and proper food, "are in the nature of reimbursement for the loss of personal rights and are not includible in . . . gross income. . . ." See also Rev. Rul. 56-518, 1956-2 C.B. 25, holding that compensation paid by West Germany to citizens or residents of the United States, formerly citizens of Germany, "pursuant to claims under its laws on account of [Nazi] persecution which resulted in damage to life, body, health, liberty, or to professional or economic advancement, are in the nature of reimbursement for the deprivation of civil or personal rights and do not constitute taxable income to the recipients."

4. *Reimbursement of expenses by public agency.* In Rev. Rul. 57-60, 1957-1 C.B. 25, modified, Rev. Rul. 60-280, 1960-2 C.B. 12, the Internal Revenue Service ruled that no income was realized by a parent who was reimbursed by a school board for transporting his children to school when school bus service was not available. See also Rev. Rul. 60-279, 1960-2 C.B. 11 (relocation payments to non-business persons for moving expenses and direct losses of property resulting from displacement by urban renewal program; held, not taxable); Rev. Rul. 63-136, 1963-29 I.R.B. 7 (benefit payments to persons undergoing retraining in areas of persistent unemployment; held, not taxable); Rev. Rul. 57-102, 1957-1 C.B. 26 (benefit payments to blind persons; not taxable). If a private employer reimburses an employee for personal expenses, however, the payment is ordinarily includible in income; page 227 infra.

HAWKINS v. COMMISSIONER

6 B.T.A. 1023 (1927)

FINDINGS OF FACT

Petitioner, an individual residing in San Francisco, Calif., was an industrial engineer engaged in corporate management. Prior to March 23, 1918, he had for some time been president of the C. L. Best Gas Traction Co. On that date he was removed from office by the directors, and thereafter certain of the officers of the corporation made and published defamatory statements about him. He instructed his attorney to file against the corporation and the individual officers a suit in libel and slander demanding $1,000,000 damages for injury to his reputation, business and health. Two of the officers of the corporation had already filed suits against the petitioner, one for libel and one for money owed by reason of an alleged misuse of corporate funds during petitioner's term of office. Before petitioner's attorney began the suit in his behalf a settlement of petitioner's claims was orally negotiated and made. By this settlement the petitioner received, on or about January 15, 1919, $100,000 in cash and the corporation's note for $12,500. He also received $306.41 as interest. In further consideration under the settlement agreement the two suits which had been begun against him were dismissed.

Opinion

STERNHAGEN: The consideration of the question whether the damages received for libel and slander are taxable as income must proceed not so much according to the refinements of economists, Lynch v. Turrish, 247 U.S. 221; Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509, as according to such decisions of the Supreme Court as mark the course. That stock dividends, Eisner v. Macomber, 252 U.S. 189; stock rights, Miles v. Safe Deposit & Trust Co., 259 U.S. 247; subsidies, Edwards v. Cuba R.R. Co., 268 U.S. 628; or savings, under certain circumstances, on the liquidation of indebtedness through a drop in foreign exchange, Bowers v. Kerbaugh-Empire Co., 271 U.S. 170, have been held not to be income; while the gain from capital sales, Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509; Goodrich v. Edwards, 255 U.S. 527; dividends in specie, Peabody v. Eisner, 247 U.S. 347; United States v. Phellis, 257 U.S. 156; and periodic payments under a will from a trust fund in which the payee has no direct interest, Irwin v. Gavit, 268 U.S. 161, have been held to be income, narrows the course but little, because the nature of the situations which gave rise to those decisions is inherently different from the question here.

The petitioner cites some of these decisions for the statement therein contained that income is the gain derived from capital or labor or both, including profit from the conversion of capital assets, and that nothing else answers the description. Whether this description of income is to be regarded as exclusive of everything not clearly within its terms, so that both the Sixteenth Amendment and the statute (which is said to be the fullest exercise of the constitutional power, Eisner v. Macomber, 252 U.S. 189; Irwin v. Gavit, 268 U.S. 161) are forever to be limited by a judicial definition, may still be doubtful, for the Supreme Court is not in the habit of defining words abstractly, but only for the purpose of determining whether the matter then under consideration comes within their fair intendment. The court has itself said that the word is not a crystal, Towne v. Eisner, 245 U.S. 418,* and it is conceivable that since the income tax is primarily an application of the idea of measuring taxes by financial ability to pay, as indicated by the net accretions to one's economic wealth during the year, there may be cases in which taxable income will be judicially found although outside the precise scope of the description already given.

This we think is not such a case, but is on the other hand one which in no event involves income. So far as the evidence shows, the amount which petitioner received was wholly by way of general damages for the personal injury suffered by reason of the defamatory statements made. It was compensation for injury to his personal reputation for integrity and fair dealing, including, as the record indicates, the injury to his health. This is the ordinary basis for compensatory damages, Childers v. San Jose Mercury Printing & Publishing Co., 105 Cal. 284; 38 Pac. 903. No suggestion is made that there was special damage paid or that any was asserted or that punitive or exemplary damages were claimed or paid, and we need not consider the law as to them. Here there is only the compensation which the law sanctions as the only remedy which has thus far been devised for an injury which in its nature is wholly personal and nonpecuniary. Even to the economist, character or reputation or other strictly personal attributes are not capital or otherwise measurable in terms of wealth, notwithstanding that all

* "But it is not necessarily true that income means the same thing in the Constitution and the Act. A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." Mr. Justice Holmes, in Towne v. Eisner, 245 U.S. 418, 425 (1918). — ED.

will recognize them as important factors of economic success. They are not property or goods. Such compensation as general damages adds nothing to the individual, for the very concept which sanctions it prohibits that it shall include a profit. It is an attempt to make the plaintiff whole as before the injury.

There is some support for this reasoning in the dictum of the Chief Justice in United States v. Supplee-Biddle Hardware Co., 265 U.S. 189, as to the insurance received by a corporation upon the life of its officer:

> . . . Life insurance in such a case is like that of fire and marine insurance, a contract of indemnity. Central Bank of Washington v. Hume, 128 U.S. 195. The benefit to be gained by death has no periodicity. It is a substitution of money value for something permanently lost, either in a house, a ship, or a life. Assuming without deciding that Congress could call the proceeds of such indemnity, income, and validly tax it as such, we think that in view of the popular conception of the life insurance as resulting in a single addition of a total sum to the resources of the beneficiary, and not in a periodical return, such a purpose on its part should be express, as it certainly is not here.

If compensation for the loss of a life is not taxable as income unless expressly provided, compensation for the injury to personal reputation should similarly require an express provision.

NOTE

1. *Loss of life.* The Internal Revenue Service has ruled that an award paid by the Mixed Claims Commission of the United States and Germany for the death of a passenger on the *Lusitania* is not taxable:

> An award paid for the loss of a life is compensation for the loss, and as such is not embraced in the general concept of the term "income." . . .
>
> It is held, therefore, that inasmuch as the award of 40*x* dollars payable to A is not expressly taxable under the provisions of the Revenue Act of 1926 [no different in this respect from any later Revenue Act], and is not embraced in the general concept of the term "income," the amount of the award is not taxable to A. [I.T. 2420, VII-2 C.B. 123, 124 (1928).]

This ruling was recently reaffirmed. Rev. Rul. 54-19, 1954-1 C.B. 179.

Note that since the award was designed "to restore A to substantially the same financial and economic status as she possessed prior to the death of her husband," it took the place of income that would have been taxed had he survived. Has the tort-feasor wronged the Treasury as well as his victim's family so that he should pay accordingly? See Wurzel, The Origin and Development of Quo Minus, 49 Yale L.J. 39 (1939). If the award *were* taxable, the position of the tort-feasor would not be an enviable one. To give a widow $75,000 free and clear, for example, would require a payment by the tort-feasor of more than $600,000 (at present rates and assuming the widow had no other income).

Do juries understand that their awards in death cases are not taxable? In Dempsey v. Thompson, 363 Mo. 339, 251 S.W.2d 42 (1952), it was held that the jury should be instructed that any award it made would not be taxable. On the other hand, the court held that although the recovery was to compensate for loss of future earnings, the defendant could not go into the extent to which such earnings would have been reduced by income taxes had the decedent not been injured, on the ground that a reasonably accurate estimate of future taxes is not possible. For an extended discussion of the extent to which federal juries in tort cases under the Federal Employers' Liability Act should be instructed (a) that the victim's lost earnings would have been taxable had the accident not occurred, (b) that the recovery will not be taxable as income upon receipt, and (c) that income earned on a recovery that is invested will be taxable, see McWeeney v. New York, New Haven, & Hartford R.R., 282 F.2d 34 (2d Cir. 1960). See also Hall v. Chicago & N.W. Ry. Co., 5 Ill. 2d 135, 150, 125 N.E.2d 77, 85 (1955) (if impact of taxation on plaintiff could be shown, plaintiff would want to go into defendant's right to deduct its tort liabilities as

business expenses, to claim higher fares, etc., "ad infinitum"); Maus v. New York, Chicago & St. L.R.R. Co., 165 Ohio St. 281, 135 N.E.2d 253 (1956); British Transport Commission v. Gourley, [1955] 3 All E.R. 796; Comment, Propriety of Comment on Non-Taxability of Personal Injury Verdicts, 21 U. of Chi. L. Rev. 156 (1953); Note, 69 Harv. L. Rev. 1945 (1956); Stevenson and Orr, The Tax Element in Damages, 1 Brit. L. Rev. 5 (1956).

2. *Statutory provisions.* Section 104 specifically exempts damages on account of personal injuries or sickness and is examined infra page 154 et seq.

The status of life insurance proceeds is also now governed by explicit statutory provisions, infra page 147.

FARMERS' & MERCHANTS' BANK v. COMMISSIONER

59 F.2d 912 (6th Cir. 1932)

Before MOORMAN, HICKS, and HICKENLOOPER, Circuit Judges.

HICKS, Circuit Judge.

Petitioner, a corporation, was engaged in the banking business at Catlettsburg, Ky., and within the district of the Federal Reserve Bank of Cleveland, Ohio. It was the custom of petitioner to make a charge for the collection of checks on foreign banks and of checks drawn on it and sent from other banks. Petitioner was not a member of the Federal Reserve System so that checks drawn on it instead of being cleared through the Reserve Bank were sent direct to petitioner by the holding bank and paid by drafts on Cincinnati or New York.

In 1920 the Reserve Bank demanded that petitioner should clear checks at par. This demand was refused, and thereupon the Reserve Bank notified its members that it would collect without charge all checks sent to it and drawn on petitioner. Its method was to employ agents who would appear daily at the bank with these checks and demand payment thereof in cash. This practice was followed about eighteen months. For a greater portion of the time these collections were effected in such an unusual and unbusinesslike manner as to attract unfavorable public comment, and petitioner claimed that it was thereby annoyed, embarrassed, and interfered with in the conduct of its affairs. Subsequently petitioner brought an action against the Reserve Bank for damages alleged to have been sustained by reason of these tactics. In its petition it set out particularly that, by reason of the wrongful conduct of the Reserve Bank, it had been forced to procure and keep in its vaults and with its correspondents unusually large amounts of money; that it had lost the earning power of a great deal of money; that it had lost deposits and depositors, and had failed to gain new ones; that it had been unable to grow, and to develop new business; and that it had been permanently injured in its reputation, standing, growth, and prosperity. The petition also included a claim for exemplary damages based upon a charge that the conduct of the Reserve Bank was malicious.

This action was compromised in 1925 and the Reserve Bank paid $18,750.00 in full settlement. The expense of the suit being deducted the net amount received by petitioner was reduced to $13,792.96. Respondent conceived that this fund represented earnings for the year 1925 and included it in petitioner's net income for that year. The Board of Tax Appeals sustained the respondent. It decided that at least some portion thereof represented earnings and that petitioner had failed to show what portion did not.

We cannot assent.

The fund involved must be considered in the light of the claim from which it was realized and which is reflected in the petition filed in its action against the Reserve Bank. We find nothing therein to indicate, with the certainty required in the statement of a cause of action, that petitioner sought reparation for profits which petitioner's misconduct prevented it from earning in 1925. Charles E.

Rous, petitioner's cashier, testified before the Board that the loss of such earnings could not be definitely determined and this probably furnishes the explanation for the failure definitely to demand it. Petitioner not only did not insist upon the restoration of anticipated profits as a matter of fact, but based its claim for damages upon an alleged tortious injury to the good will of its business, and we can see no legal distinction between compensation for destruction of or damage to incorporeal or intangible property, such as good will, and similar compensation for damage to tangible property. Compare Harris & Co. v. Lucas (C.C.A.) 48 F.(2d) 187, syl. 5.

We think that the gravamen of petitioner's action against the Reserve Bank was the injury inflicted to its banking business generally, and that the true measure of damages was compensation to be determined by ascertaining how much less valuable its business was by reason of the wrongful acts of the Reserve Bank. See Yates v. Whyel Coke Co., 221 F. 603, 607 (C.C.A. 6); Central Coal & Coke Co. v. Hartman, 111 F. 96, 99 (C.C.A. 8). Injury to its business of course means injury to its financial standing, credit, reputation, good will, capital, and other possible elements. Profits were one of the chief indications of the worth of the business; but the usual earnings before the injury, as compared with those afterward, were only an evidential factor in determining actual loss and not an independent basis for recovery. We think that, if petitioner's case had proceeded to a verdict, the law would not have awarded to it what it might have expected to gain but only that which it had actually lost. We are not justified in reading an element into the compromise which was not therein distinctly recognized in fact and would not have been recognized in law. We think therefore that there is no logical basis upon which petitioner could be charged with gain. See Strother v. Commissioner, 55 F.(2d) 626, 633 (C.C.A. 4). One may be recompensed for an injury but it is a rare case in which one should have a profit out of it.

The order of the Board of Tax Appeals is reversed.

RAYTHEON PRODUCTION CORP. v. COMMISSIONER

144 F.2d 110 (1st Cir. 1944), cert. denied, 323 U.S. 779

Before MAGRUDER, MAHONEY, and WOODBURY, Circuit Judges.

MAHONEY, Circuit Judge.

This case presents the question whether an amount received by the taxpayer in compromise settlement of a suit for damages under the Federal Anti-Trust Laws, 15 U.S.C.A. §1 et seq., is a non-taxable return of capital or income. . . .

The original Raytheon Company was a pioneer manufacturer of a rectifying tube which made possible the operation of a radio receiving set on alternating current instead of on batteries. In 1926 its profits were about $450,000; in 1927 about $150,000; and in 1928, $10,000. The Radio Corporation of America had many patents covering radio circuits and claimed control over almost all of the practical circuits. Cross-licensing agreements had been made among several companies including R.C.A., General Electric Company, Westinghouse, and American Telephone & Telegraph Company. R.C.A. had developed a competitive tube which produced the same type of rectification as the Raytheon tube. Early in 1927, R.C.A. began to license manufacturers of radio sets and in the license agreement it incorporated "Clause 9," which provided that the licensee was required to buy its tubes from R.C.A. In 1928 practically all manufacturers were operating under R.C.A. licenses. As a consequence of this restriction, Raytheon was left with only replacement sales, which soon disappeared. . . . On December 14, 1931, the petitioner caused its predecessor, Raytheon, to bring suit against R.C.A. in the District Court of Massachusetts alleging that the plaintiff had by 1926 created and then possessed a large and valuable good will in inter-

state commerce in rectifying tubes for radios and had a large and profitable established business therein so that the net profit for the year 1926 was $454,935; that the business had an established prospect of large increases and that the business and good will thereof was of a value exceeding $3,000,000; that by the beginning of 1927 the plaintiff was doing approximately 80% of the business of rectifying tubes of the entire United States; that the defendant conspired to destroy the business of the plaintiff and others by a monopoly of such business and did suppress and destroy the existing companies; that the manufacturers of radio sets and others ceased to purchase tubes from the plaintiffs; that by the end of 1927 the conspiracy had completely destroyed the profitable business and that by the early part of 1928 the tube business of the plaintiff and its property and good will had been totally destroyed at a time when it had a present value in excess of $3,000,000, and thereby the plaintiff was injured in its business and property in a sum in excess of $3,000,000. . . .

. . . R.C.A. and the petitioner finally agreed on the payment by R.C.A. of $410,000 in settlement of the anti-trust action. . . .

Damages recovered in an anti-trust action are not necessarily non-taxable as a return of capital. As in other types of tort damage suits, recoveries which represent a reimbursement for lost profits are income. Swastika Oil & Gas Co. v. Commissioner, 6 Cir., 1941, 123 F.2d 382, certiorari denied 1943, 317 U.S. 639; H. Liebes & Co. v. Commissioner, 9 Cir., 1937, 90 F.2d 932; Sternberg v. Commissioner, 1935, 32 B.T.A. 1039. The reasoning is that since the profits would be taxable income, the proceeds of litigation which are their substitute are taxable in like manner.

Damages for violation of the anti-trust acts are treated as ordinary income where they represent compensation for loss of profits. Commercial Electrical Supply Co. v. Commissioner, 1927, 8 B.T.A. 986; see Park v. Gilligan, D.C.S.D. Ohio 1921, 293 F. 129, 130.

The test is not whether the action was one in tort or contract but rather the question to be asked is "In lieu of what were the damages awarded?" Farmers' & Merchants' Bank v. Commissioner [supra p. 85]; . . . Plumb, "Income Tax on Gains and Losses in Litigation," (1940) 25 Cornell L.Q. 221. Where the suit is not to recover lost profits but is for injury to good will, the recovery represents a return of capital and, with certain limitations to be set forth below, is not taxable. Farmers' & Merchants' Bank v. Commissioner, supra. Plumb, supra, 25 Cornell L.Q. 221, 225. "Care must certainly be taken in such cases to avoid taxing recoveries for injuries to good will or loss of capital." 1 Paul and Mertens, Law of Federal Income Taxation §6.48.

Upon examination of Raytheon's declaration in its anti-trust suit we find nothing to indicate that the suit was for the recovery of lost profits. The allegations were that the illegal conduct of R.C.A. "completely destroyed the profitable interstate and foreign commerce of the plaintiff and thereby, by the early part of 1928, the said tube business of the plaintiff and the property good will of the plaintiff therein had been totally destroyed at a time when it then had a present value in excess of three million dollars and thereby the plaintiff was then injured in its business and property in a sum in excess of three million dollars." This was not the sort of anti-trust suit where the plaintiff's business still exists and where the injury was merely for loss of profits. The allegations and evidence as to the amount of profits were necessary in order to establish the value of the good will and business since that is derived by a capitalization of profits. A somewhat similar idea was expressed in Farmers' & Merchants' Bank v. Commissioner, supra, 59 F.2d at page 913. "Profits were one of the chief indications of the worth of the business; but the usual earnings before the injury, as compared with those afterward, were only an evidential factor in determining actual loss and not an inde-

pendent basis for recovery." Since the suit was to recover damages for the destruction of the business and good will, the recovery represents a return of capital. Nor does the fact that the suit ended in a compromise settlement change the nature of the recovery; "the determining factor is the nature of the basic claim from which the compromised amount was realized." Paul, Selected Studies in Federal Taxation, Second Series, pp. 328-9, footnote 76. . . .

But, to say that the recovery represents a return of capital in that it takes the place of the business good will is not to conclude that it may not contain a taxable benefit. Although the injured party may not be deriving a profit as a result of the damage suit itself, the conversion thereby of his property into cash is a realization of any gain made over the cost or other basis of the good will prior to the illegal interference. Thus A buys Blackacre for $5,000. It appreciates in value to $50,000. B tortiously destroys it by fire. A sues and recovers $50,000 tort damages from B. Although no gain was derived by A from the suit, his prior gain due to the appreciation in value of Blackacre is realized when it is turned into cash by the money damages.*

Compensation for the loss of Raytheon's good will in excess of its cost is gross income. See Magill, Taxable Income, p. 339. . . .

As the Tax Court pointed out, the record is devoid of evidence as to the amount of that basis and "in the absence of evidence of the basis of the business and good will of Raytheon, the amount of any nontaxable capital recovery cannot be ascertained." 1 T.C. 952. Cf. Sterling v. Commissioner, 2 Cir., 1937, 93 F.2d 304.

Where the cost basis that may be assigned to property has been wholly speculative, the gain has been held to be entirely conjectural and not taxable. In Strother v. Commissioner, 4 Cir., 1932, 55 F.2d 626, affirmed on other grounds, 1932, 287 U.S. 308, a trespasser had taken coal and then destroyed the entries so that the amount of coal taken could not be determined. Since there was no way of knowing whether the recovery was greater than the basis for the coal taken, the gain was purely conjectural and not taxed. Magill explains the result as follows: "as the amount of coal removed could not be determined until a final disposition of the property, the computation of gain or loss on the damages must await that disposition." Taxable Income, pp. 339-340. The same explanation may be applied to Farmers' & Merchants' Bank v. Commissioner, supra, which relied on the *Strother* case in finding no gain. The recovery in that case had been to compensate for the injury to good will and business reputation of the plaintiff bank inflicted by defendant reserve bank's wrongful conduct in collecting checks drawn on the plaintiff bank by employing "agents who would appear daily at the bank with checks and demand payment thereof in cash in such a manner as to attract unfavorable public comment." Since the plaintiff bank's business was not destroyed but only injured and since it continued in business, it would have been difficult to require the taxpayer to prove what part of the basis of its good will should be attributed to the recovery. In the case at bar, on the contrary, the entire business and good will were destroyed so that to require the taxpayer to prove the cost of the good will is no more impractical than if the business had been sold.[1]

. . . The decision of the Tax Court is affirmed.

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* Under §1033, however, A can avoid the recognition of gain on the $50,000 received for the tortious destruction of Blackacre by investing this amount promptly in other property of a similar character (infra page 466). — ED.

1 Since the plant and other physical assets of the taxpayer were not destroyed but were used by it in the new tube business under licenses from R.C.A., the recovery was only for the destruction of business good will and not the physical assets.

Section F. Increase in Net Worth

UNITED STATES v. KIRBY LUMBER CO.

284 U.S. 1 (1931)

MR. JUSTICE HOLMES delivered the opinion of the Court.

In July, 1923, the plaintiff, the Kirby Lumber Company, issued its own bonds for $12,126,800 for which it received their par value. Later in the same year it purchased in the open market some of the same bonds at less than par, the difference of price being $137,521.30. The question is whether this difference is a taxable gain or income of the plaintiff for the year 1923. By the Revenue Act of 1921, gross income includes "gains or profits and income derived from any source whatever" [1954 Code, §61(a)] and by the Treasury Regulations . . . that have been in force through repeated reënactments, "If the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year." . . . We see no reason why the Regulations should not be accepted as a correct statement of the law.

In Bowers v. Kerbaugh-Empire Co., 271 U.S. 170, the defendant in error owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment the marks had fallen in value, which so far as it went was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the contention was denied. Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here. Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365.

Judgment reversed.

BRADFORD v. COMMISSIONER

233 F.2d 935 (6th Cir. 1956)

Before MARTIN, MILLER and STEWART, Circuit Judges.

STEWART, Circuit Judge.

The question here is whether the petitioner realized $50,000 income in 1946 when her liability upon a note for $100,000 was discharged for $50,000.

In 1938 the petitioner's husband owed a Nashville bank approximately $305,000. The debt had grown out of investment banking ventures he had engaged in prior to the depression. He had pledged most of his assets to the bank as collateral, but the greater part of the indebtedness was unsecured. The brokerage firm of which he was a member held a seat on the New York Stock Exchange. In October of 1938 the Exchange adopted a rule requiring each general partner of a member firm to submit a detailed report of his indebtedness. Fearing that disclosure of so much indebtedness might impair the position of his firm with the Exchange, he persuaded the bank to substitute the note of his wife, the petitioner, for a portion of his indebtedness. Accordingly, the petitioner executed her note to the bank for $205,000 without receiving any consideration in return.

borrowed money from a bank in Germany repayable in marks. The marks were immediately converted into dollars, and the money was lost in the performance of construction contracts by a subsidiary company over a period of years. In a subsequent year, the taxpayer repaid the loan with greatly devalued marks. The question for decision was "Whether the difference between the value of marks measured by dollars at the time of payment . . . and the value when the loans were made was income." The Court decided that it was not, saying that "The loss was less than it would have been if marks had not declined in value; but the diminution of loss is not gain, profit, or income." 271 U.S. 170, 175.

The *Kerbaugh-Empire Co.* case was decided before the *Kirby Lumber Co.* and *Sanford & Brooks Co.* decisions. The case has been called "a frequently criticized and not easily understood decision." See Willard Helburn, Inc. v. Commissioner, 1 Cir., 1954, 214 F.2d 815, 819. It is nonetheless a decision which has not been overruled.[1] Whatever validity the *Kerbaugh-Empire Co.* decision may now have on its own facts, it remains an authority for the proposition that in deciding the income tax effect of cancellation of indebtedness for less than its face amount, a court need not in every case be oblivious to the net effect of the entire transaction. See Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 5 Cir., 1934, 70 F.2d 95, 96; Transylvania R. Co. v. Commissioner, 4 Cir., 1938, 99 F.2d 69, 72.

Courts have not hesitated in appropriate circumstances to look behind the cancellation of indebtedness in a given calendar year, and in doing so to evaluate in its entirety the transaction out of which the cancellation arose. Thus, it has been consistently held that the partial forgiveness of indebtedness in a given year does not constitute taxable income to the debtor if the actual effect of the entire transaction was simply to reduce the purchase price of property acquired in a prior year. Hirsch v. Commissioner, 7 Cir., 1940, 115 F.2d 656; Allen v. Courts, 5 Cir., 1942, 127 F.2d 127; Helvering v. A. L. Killian Co., 8 Cir., 1942, 128 F.2d 433.

In Commissioner v. Rail Joint Co., 2 Cir., 1932, 61 F.2d 751, a corporate taxpayer, after a reappraisal of its assets, distributed a dividend consisting of its own debenture bonds. In a subsequent year the corporation purchased some of these bonds at less than their face amounts, retired them, and credited the difference to surplus. The court rejected the Commissioner's claim that the corporation thereby realized income in the year the bonds were retired. Stripped of superficial distinctions, the *Rail Joint Co.* case is identical in principle with the present case. In that case, as in this, the taxpayer received nothing of value when the indebtedness was assumed. Although the indebtedness was discharged at less than its face value, the taxpayer was in fact poorer by virtue of the entire transaction. That the reasoning of the *Rail Joint Co.* case has not lost its vitality is attested by a very recent Tax Court opinion which approved and followed it. Fashion Park, Inc., 1954, 21 T.C. 600. A parity of reasoning requires reversal of the Tax Court's decision in the present case.

Before concluding it should be emphasized that there is not before us on this review the question of the tax liability of petitioner's husband either in 1938 when his indebtedness was assumed by his wife, or in 1946 when it was discharged, nor do we have for decision any question as to the petitioner's gift tax liability. We have decided only that the petitioner herself under the circumstances of this case did not realize $50,000 of unreported income in 1946.

For the reasons stated, the decision of the Tax Court is reversed.

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[1] The Supreme Court distinguished the *Kerbaugh-Empire Co.* case in both the *Sanford & Brooks Co.* opinion, 282 U.S. 359, 364, and the *Kirby Lumber Co.* opinion, 284 U.S. 1, 3.

NOTE

1. *Status of taxpayer's husband.* *Did* the taxpayer's husband realize income either in 1938 or in 1946? If he had borrowed money and lost it on the stock market, would a later cancellation of his debt be exempt from tax? If he had borrowed money to buy a residence and it had been destroyed by fire when uninsured, would a cancellation of the debt produce taxable income?

2. *Aftermath of wife's victory in Bradford case.* The government struggled mightily to redress its defeat in the *Bradford* case, but without success:

(a) In the original Tax Court case, the government had argued that the discharge in 1946 of the $100,000 note produced taxable income to either Mr. Bradford or Mrs. Bradford. The Tax Court absolved Mr. B, but held that Mrs. B was taxable. The government did not appeal the adverse decision as to Mr. B, but Mrs. B did appeal and was successful. Thereafter, the government assessed a deficiency against Mr. B for the year 1946, on the theory that the favorable appellate decision as to Mrs. B was inconsistent with the exclusion of the item from Mr. B's 1946 return. Without getting to the merits, the Tax Court held in Bradford v. Commissioner, 34 T.C. 1051 (1960), that the government was barred by res adjudicata and the statute of limitations, and that §§1311-1315 (mitigating the statute of limitations in certain circumstances, see pp. 875-879 infra) did not apply.

(b) The government also assessed a gift tax deficiency against Mrs. B for the year 1938, on the theory that the substitution of her notes for her husband's in that year was a taxable gift to him. In Bradford v. Commissioner, infra page 1020, the Tax Court rejected this theory.

3. *Effect of statute of limitations.* It has been held that income is realized by a debtor when his obligation becomes unenforceable because of the statute of limitations. Securities Co. v. United States, 85 F. Supp. 532 (S.D.N.Y. 1948). What is the tax consequence if he decides to pay the debt despite the running of the statute?

4. *Election to exclude income under §108.* When the cancellation of indebtedness constitutes income to the debtor, he may be able to take advantage of §108. This provision, which was enacted in 1939 as temporary legislation but has now become a permanent part of the Internal Revenue Code, provides that the taxpayer may elect not to recognize income from the discharge of a debt. The price exacted is the taxpayer's consent, under §1017, to a downward adjustment of the basis of the property to which the debt was applicable or of other assets. What is the effect of this adjustment? The election under §108 is open to all corporate taxpayers, but an individual may avail himself of it only if the canceled debt was incurred or assumed in connection with property used in his trade or business.

The *Hirsch* case, cited in *Bradford,* treated a cancellation of a purchase money obligation as a reduction of the purchase price, rather than as taxable income to the debtor. Note the similarity of this theory to the statutory option of §§108 and 1017.

5. *References.* See generally Eustice, Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion, 14 Tax L. Rev. 225 (1959); Chommie, The Debt Release: Gift or Increase in Net Worth? 4 Utah L. Rev. 36 (1954); Surrey, The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness, 49 Yale L.J. 1153 (1940); Wright, Realization of Income Through Cancellations, Modifications, and Bargain Purchases of Indebtedness: I and II, 49 Mich. L. Rev. 459, 667 (1951).

LAKELAND GROCERY CO. v. COMMISSIONER

36 B.T.A. 289 (1937)

[The taxpayer, a corporation, filed a petition in bankruptcy, action on which was delayed by the court because the taxpayer was negotiating a composition with its creditors. In order to enable the taxpayer to remain in business, certain creditors accepted $15,472 in full payment of debts in the amount of $104,710.

been a gain or a profit. In the *Dallas* case the Board held, treating the transaction as a partial forgiveness of indebtedness, although deciding the case primarily on another theory, that taxable income was realized to the extent of the amount forgiven as assets were left cleared of debts to that extent. The reasoning of the court in reversing the Board and the distinction made by it between that case and United States v. Kirby Lumber Co. are equally applicable to the facts in this proceeding and make it unnecessary to extend this opinion. Based thereon, it is my opinion that the taxpayer did not realize any income as a result of the composition settlement. See also Commissioner v. Rail Joint Co., 61 Fed. (2d) 751; Burnet v. Campbell Co.

SMITH, VAN FOSSAN, and DISNEY agree with this dissent.

NOTE

1. *Insolvency before but not after discharge of debt.* In the *Dallas Transfer & Terminal Warehouse Co.* case, it was held that a corporation did not realize income when it transferred certain assets worth about $17,500 to its landlord in full settlement of a debt for back rent in the amount of about $108,000. Despite the uncertainty expressed in the *Lakeland Grocery Co.* opinion, the Dallas Transfer Company was insolvent before the cancellation of its debt but had assets above its liabilities thereafter. Holding that the taxpayer realized no taxable income, the Court of Appeals for the Fifth Circuit distinguished the *Kirby Lumber Co.* case:

> In the [*Kirby Lumber Co.*] case a corporation issued its bonds at par and in the same year repurchased some of them at less than par. The taxpayer's assets having been increased by the cash received for the bonds, by the repurchase of some of those bonds at less than par the taxpayer, to the extent of the difference between what it received for those bonds and what it paid in repurchasing them, had an asset which had ceased to be offset by any liability, with a result that after that transaction the taxpayer had greater assets than it had before. The decision . . . that the increase in clear assets so brought about constituted taxable income is not applicable to the facts of the instant case, as the cancellation of the respondent's past due debt to its lessor did not have the effect of making the respondent's assets greater than they were before that transaction occurred. Taxable income is not acquired by a transaction which does not result in the taxpayer getting or having anything he did not have before. Gain or profit is essential to the existence of taxable income. A transaction whereby nothing of exchangeable value comes to or is received by a taxpayer does not give rise to or create taxable income. [70 F.2d 95, 96.]

2. *Wages earned by insolvent taxpayer.* A owes $250 to a credit jeweler for an engagement ring and $5000 to a judgment creditor for personal injuries caused by A's negligent driving. A has a steady job but no assets. The jeweler and judgment creditor have attached $5 and $25 of A's weekly wages. Are these amounts taxable to him? See Parkford v. Commissioner, 133 F.2d 249 (9th Cir. 1943), cert. denied, 319 U.S. 741.

3. *Settlement of disputed claim.* D purchased a secondhand automobile for $500, paying $250 in cash and agreeing to pay the balance in 30 days. He refused to pay the balance on the due date, on the ground that the seller fraudulently misrepresented the condition of the car. To settle the dispute, the seller has agreed to accept $200 in full satisfaction. Will D realize taxable income on the settlement?

4. *Discharge in bankruptcy.* For special provisions governing the cancellation of debts by a discharge in bankruptcy, see Regs. §1.61-12(b); §§268-270 of the Bankruptcy Act.

SECTION G. GIFTS, "WINDFALLS," AND THE LIKE

COMMISSIONER v. GLENSHAW GLASS CO.

348 U.S. 426 (1955)

MR. CHIEF JUSTICE WARREN delivered the opinion of the Court.

This litigation involves two cases with independent factual backgrounds yet presenting the identical issue. The two cases were consolidated for argument before the Court of Appeals for the Third Circuit and were heard en banc. The common question is whether money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble-damage antitrust recovery must be reported by a taxpayer as gross income [§61(a), 1954 Code]. In a single opinion, 211 F.2d 928, the Court of Appeals affirmed the Tax Court's separate rulings in favor of the taxpayers. 18 T.C. 860; 19 T.C. 637. Because of the frequent recurrence of the question and differing interpretations by the lower courts of this Court's decisions bearing upon the problem, we granted the Commissioner of Internal Revenue's ensuing petition for certiorari. 348 U.S. 813.

The facts of the cases were largely stipulated and are not in dispute. So far as pertinent they are as follows:

Commissioner v. Glenshaw Glass Co. — The Glenshaw Glass Company, a Pennsylvania corporation, manufactures glass bottles and containers. It was engaged in protracted litigation with the Hartford-Empire Company, which manufactures machinery of a character used by Glenshaw. Among the claims advanced by Glenshaw were demands for exemplary damages for fraud and treble damages for injury to its business by reason of Hartford's violation of the federal antitrust laws. In December, 1947, the parties concluded a settlement of all pending litigation, by which Hartford paid Glenshaw approximately $800,000. Through a method of allocation which was approved by the Tax Court, 18 T.C. 860, 870-872, and which is no longer in issue, it was ultimately determined that, of the total settlement, $324,529.94 represented payment of punitive damages for fraud and antitrust violations. Glenshaw did not report this portion of the settlement as income for the tax year involved. The Commissioner determined a deficiency claiming as taxable the entire sum less only deductible legal fees. As previously noted, the Tax Court and the Court of Appeals upheld the taxpayer.

Commissioner v. William Goldman Theatres, Inc. — William Goldman Theatres, Inc., a Delaware corporation operating motion picture houses in Pennsylvania, sued Loew's, Inc., alleging a violation of the federal antitrust laws and seeking treble damages. After a holding that a violation had occurred, William Goldman Theatres, Inc. v. Loew's, Inc., 150 F.2d 738, the case was remanded to the trial court for a determination of damages. It was found that Goldman had suffered a loss of profits equal to $125,000 and was entitled to treble damages in the sum of $375,000. William Goldman Theatres, Inc. v. Loew's, Inc., 69 F. Supp. 103, aff'd, 164 F.2d 1021, cert. denied, 334 U.S. 811. Goldman reported only $125,000 of the recovery as gross income and claimed that the $250,000 balance constituted punitive damages and as such was not taxable. The Tax Court agreed, 19 T.C. 637, and the Court of Appeals, hearing this with the *Glenshaw* case, affirmed. 211 F.2d 928.

It is conceded by the respondents that there is no constitutional barrier to the imposition of a tax on punitive damages. Our question is one of statutory construction: are these payments comprehended by §22(a) [1939 Code; §61(a), 1954 Code]?

The sweeping scope of the controverted statute is readily apparent:

Sec. 22. Gross Income.

(a) General Definition. — "Gross income" includes gains, profits and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, business, commerce, or sales, or dealing in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, *or gains or profits and income derived from any source whatever. . . .* (Emphasis added.)

This Court has frequently stated that this language was used by Congress to exert in this field "the full measure of its taxing power." Helvering v. Clifford, 309 U.S. 331, 334; Helvering v. Midland Mutual Life Ins. Co., 300 U.S. 216, 223; Douglas v. Willcuts, 296 U.S. 1, 9; Irwin v. Gavit, 268 U.S. 161, 166. Respondents contend that punitive damages, characterized as "windfalls" flowing from the culpable conduct of third parties, are not within the scope of the section. But Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted. Commissioner v. Jacobson, 336 U.S. 28, 49; Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 78-91. Thus, the fortuitous gain accruing to a lessor by reason of the forfeiture of a lessee's improvements on the rented property was taxed in Helvering v. Bruun, 309 U.S. 461. Cf. Robertson v. United States, 343 U.S. 711; Rutkin v. United States, 343 U.S. 130; United States v. Kirby Lumber Co., 284 U.S. 1. Such decisions demonstrate that we cannot but ascribe content to the catchall provision of §22(a), "gains or profits and income derived from any source whatever." The importance of that phrase has been too frequently recognized since its first appearance in the Revenue Act of 1913 to say now that it adds nothing to the meaning of "gross income."

Nor can we accept respondents' contention that a narrower reading of §22(a) is required by the Court's characterization of income in Eisner v. Macomber, 252 U.S. 189, 207, as "the gain derived from capital, from labor or from both combined." [1] The Court was there endeavoring to determine whether the distribution of a corporate stock dividend constituted a realized gain to the shareholder, or changed "only the form, not the essence," of his capital investment. Id., at 210. It was held that the taxpayer had "received nothing out of the company's assets for his separate use and benefit." Id., at 211. The distribution, therefore, was held not a taxable event. In that context — distinguishing gain from capital — the definition served a useful purpose. But it was not meant to provide a touchstone to all future gross income questions. Helvering v. Bruun, supra, at 468-469; United States v. Kirby Lumber Co., supra, at 3.

Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients. Respondents concede, as they must, that the recoveries are taxable to the extent that they compensate for damages actually incurred. It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a

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1 The phrase was derived from Stratton's Independence, Ltd. v. Howbert, 231 U.S. 399, 415, and Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185, two cases construing the Revenue Act of 1909, 36 Stat. 11, 112. Both taxpayers were "wasting asset" corporations, one being engaged in mining, the other in lumbering operations. The definition was applied by the Court to demonstrate a distinction between a return on capital and "a mere conversion of capital assets." Doyle v. Mitchell Bros. Co., supra, at 184. The question raised by the instant case is clearly distinguishable.

recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury. And we find no such evidence of intent to exempt these payments.

It is urged that re-enactment of §22(a) without change since the Board of Tax Appeals held punitive damages nontaxable in Highland Farms Corp., 42 B.T.A. 1314, indicates congressional satisfaction with that holding. Re-enactment — particularly without the slightest affirmative indication that Congress ever had the *Highland Farms* decision before it — is an unreliable indicium at best. Helvering v. Wilshire Oil Co., 308 U.S. 90, 100-101; Koshland v. Helvering, 298 U.S. 441, 447. Moreover, the Commissioner promptly published his nonacquiescence in this portion of the *Highland Farms* holding and has, before and since, consistently maintained the position that these receipts are taxable.[2] It therefore cannot be said with certitude that Congress intended to carve an exception out of §22(a)'s pervasive coverage. Nor does the 1954 Code's legislative history, with its reiteration of the proposition that statutory gross income is "all-inclusive," give support to respondents' position. The definition of gross income has been simplified, but no effect upon its present broad scope was intended.[3] Certainly punitive damages cannot reasonably be classified as gifts, cf. Commissioner v. Jacobson, 336 U.S. 28, 47-52, nor do they come under any other exemption provision in the Code. We would do violence to the plain meaning of the statute and restrict a clear legislative attempt to bring the taxing power to bear upon all receipts constitutionally taxable were we to say that the payments in question here are not gross income. See Helvering v. Midland Mutual Life Ins. Co., supra, at 223.

Reversed.

MR. JUSTICE DOUGLAS dissents.

MR. JUSTICE HARLAN took no part in the consideration or decision of this case.

NOTE

1. *Status of early rulings.* The departmental rulings referred to in footnote 2 of the *Glenshaw Glass Co.* opinion include Sol. Op. 132, I.T. 2420, and Rev. Rul. 54-19, relating to damages for alienation of affections, for defamation of personal character, for surrender of custody of a minor child, and for loss of life (supra pp. 79, 80, and 84). Does the Supreme Court endorse these rulings? If so, is it because the items involved are constitutionally immune from tax?

2. *Corporate recoveries of "insiders' profits."* In a companion case to *Glenshaw Glass Co.*, the Court held that recoveries by a corporation of profits derived by directors and major shareholders from trading in the corporation's securities, which under §16(b) of the Securities Exchange Act of 1934 "shall inure to and be recoverable by the [corporation]," constituted taxable income to the corporation:

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[2] The long history of departmental rulings holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property. See 2 Cum. Bull. 71; I-1 Cum. Bull. 92, 93; VII-2 Cum. Bull. 123; 1954-1 Cum. Bull. 179, 180. Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.

[3] In discussing §61(a) of the 1954 Code, the House Report states:

"This section corresponds to section 22(a) of the 1939 Code. While the language in existing section 22(a) has been simplified, the all-inclusive nature of statutory gross income has not been affected thereby. Section 61(a) is as broad in scope as section 22(a).

"Section 61(a) provides that gross income includes 'all income from whatever source derived.' This definition is based upon the 16th Amendment and the word 'income' is used in its constitutional sense." H.R. Rep. No. 1337, at A18.

A virtually identical statement appears in S. Rep. No. 1622, at 168.

We have this day decided that the recovery of punitive damages for fraud or antitrust violation is reportable as gross income within the meaning of §22(a). Commissioner v. Glenshaw Glass Co. The reasons which dictated that result are equally compelling here. We see no significant difference in the nature of these receipts which might make that ruling inapplicable. As in *Glenshaw*, the taxpayer realized the money in question free of any restrictions as to use. The payments in controversy were neither capital contributions nor gifts. Cf. Texas & Pacific R. Co. v. United States, 286 U.S. 285. There is no indication that Congress intended to exempt them from coverage. In accordance with the legislative design to reach all gain constitutionally taxable unless specifically excluded, we conclude that the petitioner is liable for the tax and the judgment is affirmed. [General American Investors Co. v. Commissioner, 348 U.S. at 434 (1955).]

3. *Found property.* Is found property taxable as income? What if a junk dealer finds $1000 in a drawer of a desk purchased for $5, or finds that the desk itself is a valuable antique? See Regs. §1.61-14; Dougherty v. Commissioner, ¶51,093 P-H Memo T.C. (decided before the *Glenshaw Glass Co.* case); Comment, Taxation of Found Property and Other Windfalls, 20 U. of Chi. L. Rev. 748 (1953).

4. *Subsidies.* In Edwards v. Cuba R.R. Co., 268 U.S. 628 (1925), it was held that subsidy payments received by a railroad from the government of Cuba for the construction of a new railroad "do not constitute income within the meaning of the Sixteenth Amendment." For a discussion of the present status of this case, see Freeman and Speiller, Tax Consequences of Subsidies to Induce Business Location, 9 Tax L. Rev. 255, 263-272 (1954); see also Texas & Pacific Ry. Co. v. United States, 286 U.S. 285 (1932); page 203 infra.

5. *Reference.* Wright, The Effect of the Source of Realized Benefits upon the Supreme Court's Concept of Taxable Receipts, 8 Stan. L. Rev. 164 (1956).

TAFT v. BOWERS
GREENWAY v. BOWERS
278 U.S. 470 (1929)

MR. JUSTICE MCREYNOLDS delivered the opinion of the Court.

Petitioners, who are donees of stocks, seek to recover income taxes exacted because of advancement in the market value of those stocks while owned by the donors. The facts are not in dispute. Both causes must turn upon the effect of [the predecessor of the first clause of §1015(a) of the 1954 Code], which prescribes the basis for estimating taxable gain when one disposes of property which came to him by gift. The records do not differ essentially and a statement of the material circumstances disclosed by No. 16 will suffice.

During the calendar years 1921 and 1922 the father of petitioner, Elizabeth C. Taft, gave her certain shares of Nash Motors Company stock, then more valuable than when acquired by him. She sold them during 1923 for more than their market value when the gift was made.

The United States demanded an income tax reckoned upon the difference between cost to the donor and price received by the donee. She paid accordingly and sued to recover the portion imposed because of the advance in value while the donor owned the stock. The right to tax the increase in value after the gift is not denied.

Abstractly stated, this is the problem:

In 1916 *A* purchased 100 shares of stock for $1,000, which he held until 1923 when their fair market value had become $2,000. He then gave them to *B* who sold them during the year 1923 for $5,000. The United States claim that under the Revenue Act of 1921 *B* must pay income tax upon $4,000, as realized profits. *B* maintains that only $3,000 — the appreciation during her ownership — can be regarded as income; that the increase during the donor's ownership is not income assessable against her within intendment of the Sixteenth Amendment.

The District Court ruled against the United States; the Circuit Court of Appeals held with them. . . .

We think the manifest purpose of Congress expressed in [the statute] was to require the petitioner to pay the enacted tax.*

The only question subject to serious controversy is whether Congress had power to authorize the exaction.

It is said that the gift became a capital asset of the donee to the extent of its value when received and, therefore, when disposed of by her no part of that value could be treated as taxable income in her hands.

The Sixteenth Amendment provides:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration.

Income is the thing which may be taxed — income from any source. The amendment does not attempt to define income or to designate how taxes may be laid thereon, or how they may be enforced.

Under former decisions here the settled doctrine is that the Sixteenth Amendment confers no power upon Congress to define and tax as income without apportionment something which theretofore could not have been properly regarded as income.

Also, this court has declared:

> "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets. Eisner v. Macomber, 252 U.S. 189, 207.

The "gain derived from capital," within the definition, is "not a gain accruing to capital, nor a growth or increment of value in the investment, but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested, and coming in, that is, received or drawn by the claimant for his separate use, benefit and disposal." United States v. Phellis, 257 U.S. 156, 169.

If, instead of giving the stock to petitioner, the donor had sold it at market value, the excess over the capital he invested (cost) would have been income therefrom and subject to taxation under the Sixteenth Amendment. He would have been obliged to share the realized gain with the United States. He held the stock — the investment — subject to the right of the sovereign to take part of any increase in its value when separated through sale or conversion and reduced to his possession. Could he, contrary to the express will of Congress, by mere gift enable another to hold this stock free from such right, deprive the sovereign of the possibility of taxing the appreciation when actually severed, and convert the entire property into a capital asset of the donee, who invested nothing, as though the latter had purchased at the market price? And after a still further enhancement of the property, could the donee make a second gift with like effect, etc.? We think not.

* Prior to the enactment of the statutory provision under construction (now 1954 Code, §1015(a)), the Internal Revenue Service had ruled that the basis to the donee of property received by gift was its fair market value at the time of the transfer. In 1921, the House Committee on Ways and Means reported: "This rule has been the source of serious evasion and abuse. Taxpayers having property which has come to be worth far more than it cost give such property to wives or relatives by whom it may be sold without realizing a gain unless the selling price is in excess of the value of the property at the time of the gift." To cure this practice, Congress enacted what is now the first clause of §1015 (a). At the same time, it endorsed the administrative rule for pre-1921 gifts. §1015(c). See H.R. Rept. No. 350, 67th Cong., 1st Sess., 1939-1 (Part 2) C.B. 175. — Ed.

In truth the stock represented only a single investment of capital — that made by the donor. And when through sale or conversion the increase was separated therefrom, it became income from that investment in the hands of the recipient subject to taxation according to the very words of the Sixteenth Amendment. By requiring the recipient of the entire increase to pay a part into the public treasury, Congress deprived her of no right and subjected her to no hardship. She accepted the gift with knowledge of the statute and, as to the property received, voluntarily assumed the position of her donor. When she sold the stock she actually got the original sum invested, plus the entire appreciation and out of the latter only was she called on to pay the tax demanded.

The provision of the statute under consideration seems entirely appropriate for enforcing a general scheme of lawful taxation. To accept the view urged in behalf of petitioner undoubtedly would defeat, to some extent, the purpose of Congress to take part of all gain derived from capital investments. To prevent that result and insure enforcement of its proper policy, Congress had power to require that for purposes of taxation the donee should accept the position of the donor in respect of the thing received. And in so doing, it acted neither unreasonably nor arbitrarily.

The power of Congress to require a succeeding owner, in respect of taxation, to assume the place of his predecessor is pointed out by United States v. Phellis, 257 U.S. 156, 171:

> Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he was called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations — bought "dividend on," as the phrase goes — and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question whether a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.

There is nothing in the Constitution which lends support to the theory that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property. And Irwin v. Gavit, 268 U.S. 161, 167, is to the contrary.

The judgment below is affirmed.

The CHIEF JUSTICE took no part in the consideration or decision of these causes.

NOTE

1. *Basis to donee.* Examine §1015(a) (the successor, in an amended form, of the provision involved in the foregoing case) with care. Using the illustration in the fifth paragraph of the opinion, what would B's gain or loss be if he sold the stock for $750? For $1500? What if the stock had been bought by A for $2000, had been worth $1000 at the time of the gift, and had been sold by B for $5000? For $750? for $1500?

Note §1015(a), last sentence, regarding the basis of donated property when it is impossible to ascertain the donor's basis, and see Caldwell v. Commissioner, 234 F.2d 660 (6th Cir.

1956), holding that in the absence of evidence regarding the donor's basis, neither gain nor loss is to be recognized.

Section 1015(d), added in 1958, authorizes an upward adjustment of the donee's basis for property received by gift, to reflect the federal gift tax paid on the transfer, but the basis as adjusted may not exceed the value of the property at the time of the gift.

2. *Taxability of donor.* Could the donor have been constitutionally taxed at the time of the gift on the stock's increase in value during the period he held it? Section 1015(a) seems clearly, though not explicitly, to exempt the donor, at least in ordinary circumstances. The Internal Revenue Service in recent years has ruled to the contrary in a few special situations. See Griswold, Charitable Gifts of Income and the Internal Revenue Code, 65 Harv. L. Rev. 84 (1951); Bittker, Charitable Gifts of Income and the Internal Revenue Code: Another View, id. 1375 (1952); Griswold, In Brief Reply, id. 1389; Roehner and Roehner, Realization: Administrative Convenience or Constitutional Requirement? 8 Tax L. Rev. 173 (1953). One of the rulings discussed in these articles has been revoked. Rev. Rul. 55-138, 1955-1 C.B. 223. Infra page 177.

3. *"Step-up" of basis of appreciated property at death.* Examine the first sentence of §1014(a). If in the foregoing case, the taxpayer's father had been elderly, would he have been well advised to hold the stock until death rather than transfer it by inter vivos gift?

Section H. Control and Claim of Right

UNITED STATES v. LEWIS
340 U.S. 590 (1951)

Mr. Justice Black delivered the opinion of the Court.

Respondent Lewis brought this action in the Court of Claims seeking a refund of an alleged overpayment of his 1944 income tax. The facts found by the Court of Claims are: In his 1944 income tax return, respondent reported about $22,000 which he had received that year as an employee's bonus. As a result of subsequent litigation in a state court, however, it was decided that respondent's bonus had been improperly computed; under compulsion of the state court's judgment he returned approximately $11,000 to his employer. Until payment of the judgment in 1946, respondent had at all times claimed and used the full $22,000 unconditionally as his own, in the good faith though "mistaken" belief that he was entitled to the whole bonus.

On the foregoing facts the Government's position is that respondent's 1944 tax should not be recomputed, but that respondent should have deducted the $11,000 as a loss in his 1946 tax return. See G.C.M. 16730, XV-1 Cum. Bull. 179 (1936). The Court of Claims, however, relying on its own case, Greenwald v. United States, 57 F. Supp. 569, held that the excess bonus received "under a mistake of fact" was not income in 1944 and ordered a refund based on a recalculation of that year's tax. 91 F. Supp. 1017, 1022. We granted certiorari, 340 U.S. 903, because this holding conflicted with many decisions of the courts of appeal, see, e.g., Haberkorn v. United States, 6 Cir., 173 F.2d 587, and with principles announced in North American Oil Consolidated v. Burnet [infra p. 836, where] we said:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return [i.e., to report], even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. 286 U.S. at 424.

Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim. Nor has the "claim of right" doctrine been impaired, as the Court of Claims stated, by Freuler v. Helvering, 291 U.S. 35, or

Com'r v. Wilcox, 327 U.S. 404. The *Freuler* case involved an entirely different section of the Internal Revenue Code, and its holding is inapplicable here. 291 U.S. at 43. And in Com'r v. Wilcox, we held that receipts from embezzlement did not constitute income, distinguishing *North American Oil* on the ground that an embezzler asserts no "bona fide legal or equitable claim."

Income taxes must be paid on income earned (or accrued) during an annual accounting period. Cf. [1954 Code, §§441, 451(a), and 446(a)], and see Burnet v. Sanford & Brooks Co. [infra p. 851]. The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, Law of Federal Income Taxation, §12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer.[1]

Reversed.

MR. JUSTICE DOUGLAS (dissenting).

The question in this case is not whether the bonus had to be included in 1944 income for purposes of the tax. Plainly it should have been because the taxpayer claimed it as of right. Some years later however it was judicially determined that he had no claim to the bonus. The question is whether he may then get back the tax which he paid on the money.

Many inequities are inherent in the income tax. We multiply them needlessly by nice distinctions which have no place in the practical administration of the law. If the refund were allowed, the integrity of the taxable year would not be violated. The tax would be paid when due; but the government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that payment was made on money which was not income to the taxpayer.

NOTE

The question in the foregoing case is entangled with accounting concepts, and its ramifications will be considered later. Infra pages 851-857. But the student should bear in mind that a system of annual accounting for income will inevitably breed disputes over the proper year to report numerous items and may require some to be reported in one year though they are repaid in another.

See §1341 of the 1954 Code, establishing a new rule for facts like those in the *Lewis* case. The statute assumes that the appropriate adjustment is a deduction in the later year, rather than a refund for the earlier year; but if the deduction exceeds $3000, the taxpayer may either (1) use it in the usual fashion against the later year's income, or (2) compute a tax for the later year without the deduction, and then credit against the tax thus computed that part of the earlier year's tax that resulted from including the item in income then. (Under Regs. §1.1341-1(i), the latter alternative might reduce the liability for the later year to less than zero, producing a refund to the taxpayer.) Had §1341 been in existence in 1946, Lewis could have reduced his 1946 tax by the "tax cost" to him of including the item in 1944; and thus he would have been as well off under §1341 as with a refund for 1944, except for the interest payable on refunds. It should be noted, moreover, that a taxpayer who paid little or no tax when the item was included in gross income is permitted, under §1341 as under the *Lewis* case, to deduct it from the later year's income, even though the tax benefit in that year exceeds the tax cost of the earlier inclusion.

Although the approach of §1341 is basically simple, it produces many complications, as an examination of the regulations will demonstrate.

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1 It has been suggested that it would be more "equitable" to reopen respondent's 1944 tax return. While the suggestion might work to the advantage of this taxpayer, it could not be adopted as a general solution because, in many cases, the three-year statute of limitations would preclude recovery. [1954 Code, §6511(a).]

RUTKIN v. UNITED STATES

343 U.S. 130 (1952)

MR. JUSTICE BURTON delivered the opinion of the Court.

The principal issue before us is whether money obtained by extortion is income taxable to the extortioner under §22(a) of the [1939] Code. For the reasons hereafter stated we hold that it is.

The petitioner, Rutkin, was indicted under [§7201, 1954 Internal Revenue Code], for willfully attempting to evade and defeat a large part of his income and victory taxes for 1943. He was charged with filing a false and fraudulent return stating his net income to be $18,966.64, whereas he knew that it was $268,622.04. That difference, which would increase his tax liability from $6,843.93 to $222,408.32, was due largely to his omission from his original return of $250,000 received by him in cash from Joseph Reinfeld. The United States claims that this sum was obtained by petitioner by extortion and as such was taxable income. Petitioner contests both the fact that the money was obtained by extortion and the conclusion of law that it was taxable income if so obtained. He contends also that he did not willfully attempt to evade or defeat the tax. Petitioner was found guilty by a jury in the United States District Court for the District of New Jersey, fined $10,000 and sentenced to four years in prison. The Court of Appeals affirmed, one judge dissenting. 189 F.2d 431. We granted certiorari, 342 U.S. 808, so as to pass upon the alleged conflict between that decision and the decision in Commissioner v. Wilcox, 327 U.S. 404.

The facts are unusual but there can be no doubt that, under the instructions given the jury, we must regard its verdict as reflecting its conclusion that the $250,000 was obtained by petitioner by extortion. There was substantial evidence supporting that result. Reinfeld's first association with petitioner was in 1929 with several others in a bootlegging operation known as the "High seas venture." It was accomplished through the use of a ship in the sale of whiskey at sea more than 12 miles from shore. Reinfeld testified that petitioner contributed no money to the enterprise but was taken in because Reinfeld's associates were afraid that otherwise they would get "interference and trouble" from petitioner. His interest was recognized to be 6% but, when the venture was liquidated in 1933, he already was overdrawn and no distribution was made to him. Without including petitioner, the others then organized Browne Vintners Co., Inc., a New York corporation, to engage in the liquor business. In 1936 petitioner, without making an investment, claimed a 6% interest in Browne Vintners. Despite Reinfeld's denial of petitioner's claim, Reinfeld paid him $60,000 and took from him an assignment of "any and all of such shares of capital stock in the said Browne Vintners Co., Inc., that I am entitled to." In 1940 all the Browne Vintners stock was sold for $7,500,000 to a purchaser who also assumed $8,000,000 of the company's debts. The shares of stock when sold stood in the names of, and were transferred by, "nominees" so as to conceal the identity of Reinfeld and the other beneficial owners. A capital gains tax upon the profits from these sales was paid by the respective nominees.[1] Petitioner was neither a stockholder of record nor a beneficial owner of any of the stock of the company at any time.

In 1941, in response to petitioner's request, Reinfeld gave him about $10,000 to

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[1] The United States concedes that although, on a strict construction of the Internal Revenue Code, it may be that the proceeds of the sales should have been reported by the beneficial rather than by the record owners, their failure to so report the proceeds does not provide a satisfactory basis for a charge against them of a willful attempt to evade and defeat the tax in violation of [§7201].

help buy a tavern. When petitioner used the money for other purposes Reinfeld refused to finance him further and his "trouble" with petitioner began. In 1942 petitioner again claimed that he had had an interest in Browne Vintners Company and that Reinfeld must give him $100,000 to help him pay his debts. Upon Reinfeld's refusal, petitioner threatened to kill him. From that time on, the record presents a lurid story of petitioner's unsatisfied demands upon Reinfeld for various sums up to $500,000, petitioner's threatening use of a gun and his repeated statements that he would kill Reinfeld and Reinfeld's family unless his demands were met. Finally, on May 11, 1943, in New Jersey, Reinfeld paid petitioner $250,000 in cash.

Throughout this melodrama petitioner asserted that he was entitled to the payments he demanded from Reinfeld because of petitioner's alleged former interest in Browne Vintners Company. That interest never was identified by petitioner. Reinfeld and others testified positively that petitioner never had any such interest. Nevertheless, on May 11, Reinfeld handed to petitioner $250,000 in cash at the same time that Reinfeld paid $358,000 to Zwillman and Stacher representing their conceded interest in the proceeds of Browne Vintners stock. Petitioner, with Zwillman and Stacher, thereupon signed a "general release." It did not state the amounts paid but it did purport to release Reinfeld, Browne Vintners Company and others from all claims the signers had against them.

Under the jury's verdict, we accept the fact to be that petitioner had no basis for his claim to this $250,000 and that he obtained it by extortion. Accordingly, if proceeds of extortion constitute income taxable to the extortioner, his omission of it from his tax return was unlawful. The further factual issue whether, under all the surrounding circumstances, petitioner's omission of the $250,000 from his tax return amounted to a willful attempt to evade and defeat the tax is not open to review here. That issue is settled by the verdict of the jury supported by substantial evidence. It remains for us to determine the legal issue of whether money obtained by extortion is taxable to the extortioner under §22(a) [1939 Code].

Under the instructions to the jury, extortion here meant that the $250,000 was paid to petitioner in response to his false claim thereto, his harassing demands therefor and his repeated threats to kill Reinfeld and Reinfeld's family unless the payment were made. Petitioner was unable to induce Reinfeld to believe petitioner's false and fraudulent claims to the money to be true. He induced Reinfeld to consent to pay the money by creating a fear in Reinfeld that harm otherwise would come to him and to his family. Reinfeld thereupon delivered his own money to petitioner. Petitioner's control over the cash so received was such that, in the absence of Reinfeld's unlikely repudiation of the transaction and demand for the money's return, petitioner could enjoy its use as fully as though his title to it were unassailable.

An unlawful gain, as well as a lawful one, constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it. Burnet v. Wells, 289 U.S. 670; Corliss v. Bowers, 281 U.S. 376. That occurs when cash, as here, is delivered by its owner to the taxpayer in a manner which allows the recipient freedom to dispose of it at will, even though it may have been obtained by fraud and his freedom to use it may be assailable by someone with a better title to it.

Such gains are taxable in the yearly period during which they are realized. This statutory policy is invoked in the interest of orderly administration. "[C]ollection of the revenue cannot be delayed, nor should the Treasury be compelled to decide when a possessor's claims are without legal warrant." National City Bank v. Helvering, 2 Cir., 98 F.2d 93, 96. There is no adequate reason why assailable unlawful gains should be treated differently in this respect from assailable

lawful gains. Certainly there is no reason for treating them more leniently. United States v. Sullivan, 274 U.S. 259, 263.

There has been a widespread and settled administrative and judicial recognition of the taxability of unlawful gains of many kinds under §22(a). The application of this section to unlawful gains is obvious from its legislative history. Section II, subd. B of the Income Tax Act of 1913 provided that "the net income of a taxable person shall include gains, profits, and income . . . from . . . the transaction of any *lawful* business carried on for gain or profit, or gains or profits and income derived from any source whatever. . . ." (Emphasis supplied.) 38 Stat. 167. In 1916, 39 Stat. 756, this was amended by omitting the one word "lawful" with the obvious intent thereafter to tax unlawful as well as lawful gains, profits or income derived from any source whatever.

There is little doubt now that where unlawful gains are secured by the fraud of the taxpayer they are taxable. In the instant case it is not questioned that the $250,000 would have been taxable to petitioner if he had obtained it by fraudulently inducing Reinfeld to believe petitioner's false claims to be true. That being so, it would be an extraordinary result to hold here that petitioner is to be tax free because his fraud was so transparent that it did not mislead his victim and his victim paid him the money because of fear instead of fraud.

We do not reach in this case the factual situation involved in Commissioner v. Wilcox, 327 U.S. 404. We limit that case to its facts. There embezzled funds were held not to constitute taxable income to the embezzler under §22(a). The issue here is whether money extorted from a victim with his consent induced solely by harassing demands and threats of violence is included in the definition of gross income under §22(a). We think the power of Congress to tax these receipts as income under the Sixteenth Amendment is unquestionable. The broad language of §22(a) supports the declarations of this Court that Congress in enacting that section exercised its full power to tax income. We therefore conclude that §22(a) reaches these receipts.

We have considered the other contentions of petitioner but find them without merit sufficient to justify a reversal or remand of the case.

The judgment of the Court of Appeals accordingly is affirmed.*

Affirmed.

MR. JUSTICE BLACK, with whom MR. JUSTICE REED, MR. JUSTICE FRANKFURTER, and MR. JUSTICE DOUGLAS concur, dissenting.

In Commissioner v. Wilcox, 327 U.S. 404, we held that embezzled money did not constitute taxable income to the embezzler under Section 22(a) of the [1939] Code. We there pointed out that the embezzler had no bona fide legal or equitable claim to the money, was under a definite legal obligation to return it to its rightful owner, and consequently had no more received the kind of "gain" or "income" which Congress has taxed than if he had merely borrowed money. One who extorts money not owed him stands in this precise situation. He has neither legal nor equitable claim to the extorted money and is under a continuing obligation to return it to its owner. See, e.g., Bank of the United States v. Bank of Washington, 6 Pet. 8, 19; Miller v. Eisele, 111 N.J.L. 268, 168 A. 426; 2 N.J.S.A. 2:73-1. A comparison of Mr. Justice Burton's opinion in this case with his dissent in the *Wilcox* case reveals beyond doubt that the Court today adopts the

* A petition for retrial, based on claims of newly discovered evidence and fraud by the government's principal witness, was denied by the District Court and its action was affirmed, one judge dissenting, by the Court of Appeals. United States v. Rutkin, 208 F.2d 647 (3d Cir. 1953); see also United States v. Rutkin, 212 F.2d 641 (3d Cir. 1954); Rutkin v. Reinfeld, 229 F.2d 248 (2d Cir. 1956) (civil action for damages for conspiracy to deprive plaintiff of his interest in certain liquor transactions; judgment for plaintiff reversed because transactions were unlawful). — ED.

reasoning of his prior dissent, thereby rejecting the *Wilcox* interpretation of §22(a). A tax interpretation which Congress has left in effect for six years is thus altered largely as a consequence of a change in the Court's personnel. I think that our former interpretation was right and do not believe that the Government is suffering because of a failure to collect income taxes from embezzlers and extortioners. Indeed further considerations strengthen my support of our *Wilcox* holding.

I fully agree that earnings from businesses such as gambling and bootlegging are subject to the income tax law even though these earnings are derived from illegal transactions. United States v. Sullivan, 274 U.S. 259. The majority seems to think that the *Wilcox* case holds otherwise because some states have laws which under special circumstances permit some particular groups to assert a legal claim for recovery of gambling losses or money paid for bootleg liquor. But these state laws vary far too much in their scope and operation to justify saying that these businessmen never have a bona fide legal or equitable claim to monies paid them. And ". . . we must generally assume, in the absence of a plain indication to the contrary, that Congress when it enacts a statute is not making the application of the federal act dependent on state law." Jerome v. United States, 318 U.S. 101, 104. Moreover, even if we were to take these state recoupment laws into consideration, the sums recovered under them would do no more than decrease the yearly net earnings of such questionable businesses. To all intents and purposes bootleggers and gamblers are engaged in going businesses and make regular business profit which should be taxed in the same manner as profits made through more legitimate endeavor. However, in my judgment it stretches previous tax interpretations too far to classify the sporadic loot of an embezzler, an extortioner or a robber as taxable earnings derived from a business, trade or a profession. I just do not think Congress intended to treat the plunder of such criminals as *theirs.*

It seems illusory to believe, as the majority apparently does, that the burden on honest American taxpayers will be lightened by a governmental policy of pursuing extortioners in futile efforts to collect income taxes. I venture the guess that this one trial has cost United States taxpayers more money than the Government will collect in taxes from extortioners in the next twenty-five years. If this statute is to be interpreted on the basis of what is financially best for honest taxpayers, it probably should be construed so as to save money by eliminating federal prosecutions of state crimes under the guise of punishing tax evaders.

Since it seems pretty clear that the Government can never collect substantial amounts of money from extortioners, there must be another reason for applying the tax law to money they extract from others. The Government's brief is suggestive of the only other reason that occurs to me — to give Washington more and more power to punish purely local crimes such as embezzlement and extortion. Today's decision illustrates an expansion of federal criminal jurisdiction into fields of law enforcement heretofore wholly left to states and local communities. I doubt if this expansion is wise from the standpoint of the United States or the states.

Insofar as the United States is concerned, many think that taking over enforcement of local criminal laws lowers the prestige of the federal system of justice. It certainly tends to make the federal system top-heavy. Of supreme importance is the fact that the United States cannot perform the monumental tasks which lie beyond state power if the time, energy and funds of federal institutions are expended in the field of state criminal law enforcement.

Federal encroachment upon local criminal jurisdiction can also be very injurious to the states. Extortion. robbery, embezzlement and offenses of that nature

are traditionally matters of local concern. The precise elements of these offenses as well as the problems underlying them vary from state to state. Federal assumption of the job of enforcing these laws must of necessity tend to free the states from a sense of responsibility for their own local conditions. Even when states attempt to play their traditional role in the field of law enforcement, the overriding federal authority forces them to surrender control over the manner and policy of construing and applying their own laws. State courts not only lose control over the interpretation of their own laws, but also are deprived of the chance to use the discretion vested in them by state legislatures to impose sentences in accordance with local ideas. Moreover, state prosecutors are deprived of the all-important function of deciding what local offenders should be prosecuted. Final authority to make these important decisions becomes located in the distant city of Washington, D.C. Here, as elsewhere, too many cooks may spoil the broth.

Moreover, I doubt if this expansion of federal criminal jurisdiction can be carried on in a manner consistent with our traditional ideas of what constitutes a fair trial in criminal cases. There is the question of the wisdom and fairness of subjecting a person to double and even triple prosecutions for the same conduct, since the nation, state and municipality might make this one mistake or wrong punishable as a crime.

That consideration gives additional weight to the view that where Congress is creating offenses which duplicate or build upon state law, courts should be reluctant to expand the defined offenses beyond the clear requirements of the terms of the statute. [Jerome v. United States, supra, 318 U.S. at page 105.]

Of course, looked at technically, multiple prosecutions for the same conduct could be avoided by national prosecution of one part of the conduct, state prosecution of another part, and municipal prosecution of a third part. This would still leave a defendant faced with the burden of defending three separate prosecutions.

Expansion of federal criminal jurisdiction entails many other unfair and complicating factors. Criminal rules of substance and of procedure vary widely among the jurisdictions. Punishment is frequently different. In fact, the same kind of conduct may be ignored as not worth criminal punishment by one jurisdiction while considered a serious criminal offense by another. For example, under the Federal White Slave Law men can be imprisoned five years for conduct which many states would not hold criminal at all. Schwartz, "Federal Criminal Jurisdiction and Prosecutors' Discretion," 13 Law and Contemporary Problems 64, 72. When faced with specific federal legislation, such differences in treatment may be inevitable, but I do not think the tax laws should be judicially extended for the purpose of taking from local officials the responsibility for prosecuting local offenses.

When the Government takes over a case like the one before us, the resulting confusion of issues is manifestly prejudicial to the defendant. Here for instance it can hardly be said that Rutkin was tried for tax evasion. Most of the 900 printed pages of oral testimony in the two weeks' trial are devoted to proof of things other than an attempt to evade the tax. Four pages deal with Rutkin's allegedly false 1943 tax return; three pages deal with the amount of tax Rutkin would have owed if he had received $250,000 more income than he actually reported; six pages contain testimony of Rutkin tending to show willful evasion of the tax laws so as to bring the case within Spies v. United States, 317 U.S. 492. A mere reference to the contents of the remaining 887 pages shows what a great threat there was that Rutkin would be convicted because he was a "bad man"

("scoundrel" to use the trial court's title) regardless of whether he was guilty or innocent of the tax evasion charged.

Most of the evidence dealt with the following aspects of Rutkin's past life and associations: Back in prohibition days Rutkin had joined one Reinfeld and others in a bootlegging scheme called the "High seas venture." The organization made millions. About 1940, some time after prohibition ended, Reinfeld, apparently acting for the group, sold the business establishment for about $7,500,000 net. Reinfeld's accounting methods and management of the proceeds were not satisfactory to his associates. They claimed that Reinfeld held back more than his share of the millions. Reinfeld claimed that some of his former associates, including Rutkin, were "overdrawn" and entitled to nothing out of the $7,500,000. This quarrel went on for several years during which time Reinfeld was required to pay hundreds of thousands of dollars to former partners as a result of their claims that he had swindled them. Rutkin was one of them. Rutkin's $250,000 was paid to him by lawyers whose reputations seem to have been above reproach. It was paid openly. And it was some eight years later when Rutkin sued Reinfeld for more millions that Reinfeld, apparently for the first time, charged that Rutkin had extorted the $250,000 under threats of death. Yet he has been convicted here of federal tax evasion on the theory that he was guilty of the crime of "extortion."

From the beginning to the end the evidence in this case was devoted to showing the lawless life Rutkin, Reinfeld and their associates led from the 1920's to 1950, ranging from bootlegging to bribery to gambling. The charge of the court largely emphasized and reemphasized the iniquity of the criminal conduct shown by the testimony. Early in his charge the trial court told the jury:

> You are not deciding which is the bigger scoundrel, Reinfeld or Rutkin; they have both blandly admitted on the stand that they prostituted justice in this country; that they paid public servants to close their eyes to law violation, and that is a canker which eats away at the body public. But you are not passing upon respective degrees of scoundrelism between any two people. The bland way in which we were told that the Reinfelds and the Rutkins and the Zwillmans and all of the others prostituted justice should give us cause for pause, but we are not passing on that question now.

In concluding his charge the trial court told the jury:

> The Government of the United States doesn't ask you to sacrifice anybody to prove its might. It asks you to do justice. That's all that Rutkin has a right to ask you to do, and that's what the government of the United States asks you to do. It asks you to remember its rights too, remembering that unpunished crime, undetected crime, are threats to the majesty and dignity of our government; and that unpunished crime undermines our government. We all of us must do that which is our duty and do it without fear or favor.

My study of this record leads me to believe that the fantastic story of supposed extortion told here would probably never have been accepted by a jury if presented in a trial uncolored by the manifold other inflammatory matters which took up 887 of the 900 pages in this "tax evasion" case.

If we are going to depart from the *Wilcox* holding, I think this is a poor case in which to do so. I would reverse this judgment.

JAMES v. UNITED STATES

366 U.S. 313 (1961)

MR. CHIEF JUSTICE WARREN announced the judgment of the Court and an opinion in which MR. JUSTICE BRENNAN and MR. JUSTICE STEWART concur.

The issue before us in this case is whether embezzled funds are to be included

in the "gross income" of the embezzler in the year in which the funds are misappropriated under §22(a) of the Internal Revenue Code of 1939 and §61(a) of the Internal Revenue Code of 1954.

The facts are not in dispute. The petitioner is a union official who, with another person, embezzled in excess of $738,000 during the years 1951 through 1954 from his employer union and from an insurance company with which the union was doing business. Petitioner failed to report these amounts in his gross income in those years and was convicted for willfully attempting to evade the federal income tax due for each of the years 1951 through 1954 in violation of §145(b) of the Internal Revenue Code of 1939 and §7201 of the Internal Revenue Code of 1954. He was sentenced to a total of three years' imprisonment. The Court of Appeals affirmed. 273 F.2d 5. Because of a conflict with this Court's decision in Commissioner v. Wilcox, 327 U.S. 404, a case whose relevant facts are concededly the same as those in the case now before us, we granted certiorari. 362 U.S. 974. . . .

The basis for the *Wilcox* decision was "that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain. Without some bona fide legal or equitable claim, even though it be contingent or contested in nature, the taxpayer cannot be said to have received any gain or profit within the reach of §22(a)." Commissioner v. Wilcox, supra, at p. 408. Since Wilcox embezzled the money, held it "without any semblance of a bona fide claim of right," ibid., and therefore "was at all times under an unqualified duty and obligation to repay the money to his employer," ibid., the Court found that the money embezzled was not includible within "gross income." But, Rutkin's legal claim was no greater than that of Wilcox. It was specifically found "that petitioner had no basis for his claim . . . and that he obtained it by extortion." Rutkin v. United States [343 U.S. 130], at p. 135. Both Wilcox and Rutkin obtained the money by means of a criminal act; neither had a bona fide claim of right to the funds.[1] Nor was Rutkin's obligation to repay the extorted money to the victim any less than that of Wilcox. The victim of an extortion, like the victim of an embezzlement, has a right to restitution. Furthermore, it is inconsequential that an embezzler may lack title to the sums he appropriates while an extortionist may gain a voidable title. Questions of federal income taxation are not determined by such "attenuated subtleties." Lucas v. Earl, 281 U.S. 111, 114; Corliss v. Bowers, 281 U.S. 376, 378. Thus, the fact that Rutkin secured the money with the consent of his victim, Rutkin v. United States, supra, at p. 138, is irrelevant. Likewise unimportant is the fact that the sufferer of an extortion is less likely to seek restitution than one whose funds are embezzled. What is important is that the right to recoupment exists in both situations. . . .

The starting point in all cases dealing with the question of the scope of what is included in "gross income" begins with the basic premise that the purpose of Congress was "to use the full measure of its taxing power." Helvering v. Clifford, 309 U.S. 331, 334. And the Court has given a liberal construction to the broad phraseology of the "gross income" definition statutes in recognition of the inten-

[1] The Government contends that the adoption in *Wilcox* of a claim of right test as a touchstone of taxability had no support in the prior cases of this Court; that the claim of right test was a doctrine invoked by the Court in aid of the concept of annual accounting, to determine *when*, not *whether*, receipts constituted income. See North American Oil v. Burnet, 286 U.S. 417; United States v. Lewis, 340 U.S. 590; Healy v. Commissioner, 345 U.S. 278. In view of our reasoning set forth below, we need not pass on this contention. The use to which we put the claim of right test here is only to demonstrate that, whatever its validity as a test of *whether* certain receipts constitute income, it calls for no distinction between *Wilcox* and *Rutkin*.

tion of Congress to tax all gains except those specifically exempted. Commissioner v. Jacobson, 336 U.S. 28, 49; Helvering v. Stockholms Enskilda Bank, 293 U.S. 84, 87-91. The language of §22(a) of the 1939 Code, "gains or profits and income derived from any source whatever," and the more simplified language of §61(a) of the 1954 Code, "all income from whatever source derived," have been held to encompass all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 431. A gain "constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it." Rutkin v. United States, supra, at p. 137. Under these broad principles, we believe that petitioner's contention, that all unlawful gains are taxable except those resulting from embezzlement, should fail.

When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." North American Oil v. Burnet, supra, at p. 424. In such case, the taxpayer has "actual command over the property taxed — the actual benefit for which the tax is paid," Corliss v. Bowers, supra. This standard brings wrongful appropriations within the broad sweep of "gross income"; it excludes loans. When a law-abiding taxpayer mistakenly receives income in one year, which receipt is assailed and found to be invalid in a subsequent year, the taxpayer must nonetheless report the amount as "gross income" in the year received. United States v. Lewis, supra; Healy v. Commissioner, supra. We do not believe that Congress intended to treat a law-breaking taxpayer differently. Just as the honest taxpayer may deduct any amount repaid in the year in which the repayment is made, the Government points out that, "If, when, and to the extent that the victim recovers back the misappropriated funds, there is of course a reduction in the embezzler's income." Brief for the United States, p. 24.

[The Chief Justice then considered, and rejected, the taxpayer's argument that the *Wilcox* ruling had been endorsed by Congressional re-enactment of the Code in 1954 and by its failure to enact a bill to change the rule.]

But, we are dealing here with a felony conviction under statutes which apply to any person who "willfully" fails to account for his tax or who "willfully" attempts to evade his obligation. In Spies v. United States, 317 U.S. 492, 499, the Court said that [§7201] embodied "the gravest of offenses against the revenues," and stated that willfulness must therefore include an evil motive and want of justification in view of all the circumstances. Id., at 498. Willfulness "involves a specific intent which must be proven by independent evidence and which cannot be inferred from the mere understatement of income." Holland v. United States, 348 U.S. 121, 139.

We believe that the element of willfulness could not be proven in a criminal prosecution for failing to include embezzled funds in gross income in the year of misappropriation so long as the statute contained the gloss placed upon it by *Wilcox* at the time the alleged crime was committed. Therefore, we feel that petitioner's conviction may not stand and that the indictment against him must be dismissed.

Since MR. JUSTICE HARLAN, MR. JUSTICE FRANKFURTER, and MR. JUSTICE CLARK agree with us concerning *Wilcox,* that case is overruled. MR. JUSTICE BLACK, MR. JUSTICE DOUGLAS, and MR. JUSTICE WHITTAKER believe that petitioner's conviction must be reversed and the case dismissed for the reasons stated in their opinions.

Accordingly, the judgment of the Court of Appeals is reversed and the case is remanded to the District Court with directions to dismiss the indictment.

It is so ordered.

MR. JUSTICE BLACK, whom MR. JUSTICE DOUGLAS joins, concurring in part and dissenting in part.

. . .

I

We dissent from the way the majority of the Court overrules *Wilcox*. If the statutory interpretation of "taxable income" in *Wilcox* is wrong, then James is guilty of violating the tax evasion statute for the trial court's judgment establishes that he embezzled funds and wilfully refrained from reporting them as income. It appears to us that District Courts are bound to be confused as to what they can do hereafter in tax-evasion cases involving "income" from embezzlements committed prior to this day. Three Justices vote to overrule *Wilcox* under what we believe to be a questionable formula, at least a new one in the annals of this Court, and say that although failure to report embezzled funds has, despite *Wilcox*, always been a crime under the statute, people who have violated this law in the past cannot be prosecuted but people who embezzle funds after this opinion is announced can be prosecuted for failing to report these funds as a "taxable gain." Three other Justices who vote to overrule *Wilcox* say that past embezzlers can be prosecuted for the crime of tax evasion although two of those Justices believe the Government must prove that the past embezzler did not commit his crime in reliance on *Wilcox*. Thus, although it was not the law yesterday, it will be the law tomorrow that funds embezzled hereafter are taxable income; and although past embezzlers could not have been prosecuted yesterday, maybe they can and maybe they cannot be prosecuted tomorrow for the crime of tax evasion. (The question of the civil tax liability of past embezzlers is left equally unclear.) We do not challenge the wisdom of those of our Brethren who refuse to make the Court's new tax evasion crime applicable to past conduct. This would be good governmental policy even though the ex post facto provision of the Constitution has not ordinarily been thought to apply to judicial legislation. Our trouble with this aspect of the Court's action is that it seems to us to indicate that the Court has passed beyond the interpretation of the tax statute and proceeded substantially to amend it.

We realize that there is a doctrine with wide support to the effect that under some circumstances courts should make their decisions as to what the law is apply only prospectively. Objections to such a judicial procedure, however, seem to us to have peculiar force in the field of criminal law. In the first place, a criminal statute that is so ambiguous in scope that an interpretation of it brings about totally unexpected results, thereby subjecting people to penalties and punishments for conduct which they could not know was criminal under existing law, raises serious questions of unconstitutional vagueness. Moreover, for a court to interpret a criminal statute in such a way as to make punishment for past conduct under it so unfair and unjust that the interpretation should be given only prospective application seems to us to be the creation of a judicial crime that Congress might not want to create. This country has never been sympathetic with judge-created crimes. Their rejection under our Constitution was said to have been "long since settled in public opinion" even as early as 1812 when the question first reached this Court in United States v. Hudson & Goodwin, 7 Cranch 32. In that case this Court emphatically declared that the federal courts have no common-law jurisdiction in criminal cases. They are not "vested with jurisdic-

tion over any particular act done by an individual in supposed violation of the peace and dignity of the sovereign power." Rather, "[t]he legislative authority of the Union must first make an act a crime, affix a punishment to it, and declare the Court that shall have jurisdiction of the offense."

In our judgment one of the great inherent restraints upon this Court's departure from the field of interpretation to enter that of lawmaking has been the fact that its judgments could not be limited to prospective application. This Court and in fact all departments of the Government have always heretofore realized that prospective lawmaking is the function of Congress rather than of the courts. We continue to think that this function should be exercised only by Congress under our constitutional system.

II

We think *Wilcox* was right when it was decided and is right now. It announced no new, novel doctrine. One need only look at the Government's briefs in this Court in the *Wilcox* case to see just how little past judicial support could then be mustered had the Government sought to send Wilcox to jail for his embezzlement under the guise of a tax evasion prosecution. The Government did cite many cases from many courts saying that under the federal income tax law gains are no less taxable because they have been acquired by illegal methods. This Court had properly held long before *Wilcox* that there is no "reason why the fact that a business is unlawful should exempt it from paying the taxes that if lawful it would have to pay." We fully recognized the correctness of that holding in *Wilcox:*

> Moral turpitude is not a touchstone of taxability. The question, rather, is whether the taxpayer in fact received a statutory gain, profit or benefit. That the taxpayer's motive may have been reprehensible or the mode of receipt illegal has no bearing upon the application of §22(a).

The Court today by implication attributes quite a different meaning or consequence to the *Wilcox* opinion. One opinion argues at length the "well-established principle . . . that unlawful, as well as lawful, gains are comprehended within the term 'gross income.' " *Wilcox* did not deny that; we do not deny that. This repeated theme of our Brethren is wholly irrelevant since the *Wilcox* holding in no way violates the sound principle of treating "gains" of honest and dishonest taxpayers alike. The whole basis of the *Wilcox* opinion was that an embezzlement is not in itself "gain" or "income" to the embezzler within the tax sense, for the obvious reason that the embezzled property still belongs, and is known to belong, to the rightful owner. It is thus a mistake to argue that petitioner's contention is "that all unlawful gains are taxable except those resulting from embezzlement." . . .

. . . The rightful owner who has entrusted his funds to an employee or agent has troubles enough when those funds are embezzled without having the Federal Government step in with its powerful claim that the embezzlement is a taxable event automatically subjecting part of those funds (still belonging to the owner) to the waiting hands of the Government's tax gatherer. We say part of the *owner's* funds because it is on the supposed "gain" from them that the embezzler is now held to be duty-bound to pay the tax and history probably records few instances of independently wealthy embezzlers who have had nonstolen assets available for payment of taxes.

There has been nothing shown to us on any of the occasions when we have considered this problem to indicate that Congress ever intended its income tax

laws to be construed as imposing what is in effect a property or excise tax on the rightful owner's embezzled funds, for which the owner has already once paid income tax when he rightfully acquired them. In our view, the Court today does Congress a grave injustice by assuming that it has imposed this double tax burden upon the victim of an embezzlement merely because someone has stolen his money, particularly when Congress has refused requests that it do so. The owner whose funds have been embezzled has done nothing but entrust an agent with possession of his funds for limited purposes, as many of us have frequent occasion to do in the course of business or personal affairs. Ordinarily the owner is not, and has no reason to be, at all aware of an embezzlement until long after the first misuse occurs. If Congress ever did manifest an intention to select the mere fact of embezzlement as the basis for imposing a double tax on the owner, we think a serious question of confiscation in violation of the Fifth Amendment would be raised. All of us know that with the strong lien provisions of the federal income tax law an owner of stolen funds would have a very rocky road to travel before he got back, without paying a good slice to the Federal Government, such funds as an embezzler who had not paid the tax might, perchance, not have dissipated. An illustration of what this could mean to a defrauded employer is shown in this very case by the employer's loss of some $700,000, upon which the Government claims a tax of $559,000. . . .

In departing from both the *Wilcox* and *Rutkin* decisions today, our Brethren offer no persuasive reasons to prove that their judgment in overruling *Wilcox* is better than that of the Justices who decided that case. It contributes nothing new to the analysis of this problem to say repeatedly that the dishonest man must be subject to taxation just as the honest. As already said, Chief Justice Stone and the others sitting with him on the *Wilcox* Court fully accepted that general principle and we do still. Applying it here, we would say the embezzler should be treated just like the law-abiding, honest borrower who has obtained the owner's consent to his use of the money.[1] It would be unthinkable to tax the borrower on his "gain" of the borrowed funds and thereby substantially impair the lender's chance of ever recovering the debt. The injury that the Government would inflict on the lender by making the borrower less able to repay the loan surely would not be adequately compensated by telling the lender that he can take a tax deduction for the loss, and it is equally small comfort to the embezzlement victim for the Government, after taking part of his property as a tax on the embezzler, to tell the victim that he can take a deduction for his loss if he has any income against which to offset the deduction. There is, of course, one outstanding distinction between a borrower and an embezzler, and that is that the embezzler uses the funds without the owner's consent. This distinction can be of

[1] The analogy between the borrower and the embezzler was lucidly analyzed by Judge Sibley in McKnight v. Commissioner, 127 F.2d 572, 573-574.

The several cases relied on by the Court do not, in our judgment, justify imposing a tax upon embezzled money. Corliss v. Bowers, 281 U.S. 376, involved income accumulating in a trust fund belonging to the taxpayer and over which he retained control. North American Oil Consolidated v. Burnet, 286 U.S. 417; United States v. Lewis, 340 U.S. 590; and Healy v. Commissioner, 345 U.S. 278, were cases in which the taxpayer had asserted a bona fide, though mistaken, claim of right. In *North American Oil*, the taxpayer not only had a bona fide claim to the money taxed, but there had been an adjudication that he was entitled to it, and there was only the tenuous possibility that a competing claimant might later upset that adjudication. The *Lewis* and *Healy* cases involved a tax on payments made and received as a result of mutual mistake, and it was held that the administration of the tax laws on an annual basis need not be upset for the convenience of those who caused the mistaken payments to be made and reported as income. By contrast, the victims do not cause embezzlements, and the Government is not misled or inconvenienced under *Wilcox* because the embezzler is always fully aware that the embezzled funds are not rightfully his and presumably will not report otherwise.

no importance for purposes of taxability of the funds, however, because as a matter of common sense it suggests that there is, if anything, less reason to tax the embezzler than the borrower. But if this distinction is to be the reason why the embezzlement must be taxed just as "the gains of the honest laborer," then the use of this slogan in this case is laid bare as no more than a means of imposing a second punishment for the crime of embezzlement without regard to revenue considerations, the effect on the rightful owner, or the proper role of this Court when asked to overrule a criminal statutory precedent. The double jeopardy implications would seem obvious,[2] and discussion of the serious inadvisability for other reasons of thus injecting the Federal Government into local law enforcement can be found in the dissenting opinion in *Rutkin*. . . .

[Mr. Justice Harlan, joined by Mr. Justice Frankfurter, agreed with the overruling of *Wilcox,* but would have remanded the case for a new trial in which the defendant would be permitted to prove that he relied on, or was misled by, *Wilcox* in failing to report the receipts in question.

Mr. Justice Whittaker, joined by Mr. Justice Black and Mr. Justice Douglas, concurred in part and dissented in part, arguing that the embezzler does not realize income because of his offsetting obligation to make restitution to his victim.

Mr. Justice Clark agreed with the overruling of *Wilcox,* but would have affirmed the conviction because *Wilcox* was overruled sub silentio in the *Glenshaw Glass Co.* case and in any event was not relied on by the defendant.]

NOTE

1. *Scope of Rutkin and James cases.* Are the profits of larceny and robbery taxable? If not, are the federal courts to distinguish between the crimes of embezzlment, larceny by trick and device, and false pretenses on the basis of the "attenuated subtleties" of common law? Does the Court hold that a repayment by an embezzler is deductible in the year of repayment on the theory that it is an "ordinary and necessary expense" of carrying on a "trade or business" within the meaning of §162(a)?

Note the reference in Chief Justice Warren's opinion in *James* to earnings acquired "without the consensual recognition, express or implied, of an obligation to repay." If a bank clerk "borrows" from the bank, intending to repay the funds as soon as his ship (or horse) comes in, is he subject to tax?

2. *Implications of dissenting opinions.* Do the dissenters in the *Rutkin* and *James* cases believe that it is unconstitutional to tax extortioners and embezzlers, or only that Congress did not intend to tax them? Would they tolerate a tax, or a prosecution, if the government had waited until the year in which the statute of limitations (if there is one) ran on a recovery of the embezzled or extorted funds by the victim, or until the victim forgave the wrongdoer? Would such a delay obviate the concern expressed in the *James* dissent about double taxation, double jeopardy, or double punishment or the concern of the dissenting Justices in *Rutkin* about federal encroachment on local criminal jurisdiction?

3. *Competing claims of victim and tax collector.* Would the government's tax claim against Rutkin and James be superior to the claim of the victim if both could not be paid in full? Can the victim protect himself by forgiving the tort and electing to treat the transaction as a loan? See generally Note, Taxation of Misappropriated Property: The Decline and Incomplete Fall of *Wilcox,* 62 Yale L.J. 662 (1953).

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2 See the dissenting opinion in Bartkus v. Illinois, 359 U.S. 121, 150. It is interesting to note that on July 22, 1959, shortly after the *Bartkus* decision, Illinois, in order to avoid the danger of prosecuting men in both state and federal courts for the same crime, passed a statute making conviction or acquittal in a federal prosecution a defense to a state prosecution for the same criminal act. Illinois Laws, 1959, p. 1893, §1; 38 Ill. Ann. Stat. (Cum. Supp. 1960) §601.1. Thus, while Illinois is moving away from such double prosecutions, this Court is moving even further than *Barthus* in the direction of authorizing such prosecutions.

4. *Impact of Wilcox case in practice.* During the years when the *Wilcox* case was in full force and effect, it was invoked more often by businessmen masquerading as embezzlers than by what might be termed "bona fide embezzlers." The typical situation was a civil or criminal fraud action based on the fact that an officer or shareholder of a one-man or closely held corporation had pocketed some of the corporation's cash receipts and had omitted them from both the corporate and his individual tax returns. If the Internal Revenue Service alleged an understatement of the corporation's taxable income and tax liability, the defense was that the funds had been embezzled from the corporation, so that it was entitled to a deduction for a loss by theft equal to, and hence offsetting, the amount omitted from its gross receipts. If, on the other hand, the Internal Revenue Service alleged a wrongful omission from the officer's personal tax returns of the funds taken from the corporation, he relied on the *Wilcox* case to negate tax liability. On the whole, the courts resisted these attempts to exploit the *Wilcox* case, sometimes on the theory that a shareholder cannot embezzle from his wholly owned corporation, sometimes on finding that the corporation suffered no loss because the shareholder was financially able to make restitution. In one ironic twist of the screw, the Tax Court refused to accept a taxpayer's claim that he was an embezzler partly because his admission that he had engaged in fraud made him unworthy of belief. See Kann v. Commissioner, 18 T.C. 1032 (1952), affirmed by a divided court, 210 F.2d 247 (3d Cir. 1954); Davis v. United States, 226 F.2d 331 (6th Cir. 1955) ("stockholder could not embezzle funds from his wholly owned corporation"); but see Dix v. Commissioner, 223 F.2d 436 (2d Cir. 1955), finding that the president (who was not the sole shareholder and who had deceived the only other responsible executive) had embezzled from a family corporation.

5. *Willfulness.* On the impossibility (as a majority in the *James* case saw it) of proving willfulness, so long "as the statute contained the gloss placed upon it by *Wilcox* at the time the alleged crime was committed": is a Supreme Court decision the only kind of "gloss" that is inconsistent with willfulness? What about a string of decisions by the Tax Court? Could the civil fraud penalty of §6653(b) or the negligence penalty of §6653(a) (infra pp. 948-958) be imposed on the taxpayer in the *James* case? If embezzlement was his only source of income and he did not file a return, was his failure "due to reasonable cause and not due to willful neglect" so that the addition of §6651(a) does not apply?

6. *Disclosure of illegal income and the Fifth Amendment.* Although it was held as long ago as 1927 that illegal income is taxable, United States v. Sullivan, 274 U.S. 259 (1927), involving the income of a bootlegger during Prohibition, the extent to which recipients of such income must keep records and report the details on their tax returns is still uncertain. The taxpayer can not be compelled to give self-incriminating testimony; can he be required to keep books and records or to execute a tax return that will incriminate him? Does disclosure of activities (e.g., gambling; unlawful sale of liquor) that are illegal under state law rest on a different footing from disclosure of federal crimes?

In the *Sullivan* case, Mr. Justice Holmes, writing for a unanimous court, said only:

> If the form of return provided called for answers that the defendant was privileged from making he could have raised the objection in the return, but could not on that account refuse to make any return at all. We are not called on to decide what, if anything, he might have withheld. Most of the items warranted no complaint. It would be an extreme if not an extravagant application of the Fifth Amendment to say that it authorized a man to refuse to state the amount of his income because it had been made in crime. [274 U.S. at 263.]

Investigations in recent years by the Kefauver Committee and others have revealed that when illegal income is reported, it is often designated merely as "commissions," "fees," "other income," and the like, rather than labeled specifically. Must the government tolerate this kind of reporting?

In Shapiro v. United States, 335 U.S. 1 (1948), it was held that the privilege against self-incrimination does not extend so far as to permit the taxpayer to withhold from the government "records required to be kept by a valid regulation under the Price Control Act" at least "when there is a sufficient relation between the activity sought to be regulated and the public concern so that the government can constitutionally regulate or forbid the basic

activity concerned, and can constitutionally require the keeping of particular records, subject to inspection by the Administrator." As to the relation of all this to tax returns and to records kept for tax purposes, see Redlich, Searches, Seizures, and Self-incrimination in Tax Cases, 10 Tax L. Rev. 191 (1954); Meltzer, Required Records, the McCarran Act, and the Privilege Against Self-incrimination, 18 U. of Chi. L. Rev. 687, 708-719 (1951).

In U.S. v. Clancy, 276 F.2d 617 (7th Cir. 1960), involving a prosecution for evasion of federal wagering taxes, the court cited the *Shapiro* case in holding that a seizure of the taxpayer's books and records by federal revenue agents did not violate the Fourth and Fifth Amendments because, inter alia, they were records that he was required by law to keep and make available for official inspection, rather than "private papers." The decision was reversed, but on another ground, 365 U.S. 312 (1961). See also Falsone v. United States, 205 F.2d 734 (5th Cir. 1953), stating that the privilege against self-incrimination does not extend to books kept pursuant to §6001; In re Daniels, 140 F. Supp. 322 (S.D.N.Y. 1956) (contra); United States v. Kahriger, 345 U.S. 22 (1953), sustaining the validity of the excise tax on persons engaged in the business of accepting wagers against objections based on the Fifth Amendment; Lewis v. United States, 348 U.S. 419 (1955), upholding the tax in the District of Columbia, where gambling is a federal crime.

CHAPTER 2

The Individual, Non-business Taxpayer

SECTION A. NON-TAXABLE ITEMS

Chapter 1 is concerned with the "outer limits" of federal income taxation. There we saw, among other things, that not everything that comes in is income. Some of the exempt items were found to be immune on constitutional grounds, though others were protected on the theory that Congress did not intend to tax them and others perhaps only because the rulings or decisions concerning them have not been challenged in recent years. At any rate, Chapter 1's exempt items were not placed beyond the tax collector's reach by any specific statutory exemption.

Now we will examine a variety of specific statutory exemptions. For the most part, these exemptions apply to items that would otherwise be taxable; but in some cases the exemption was originally enacted because the item in question was thought to be constitutionally immune to tax, and the continued existence of the statutory exemption has made it unnecessary for the courts to pass on the constitutional issue.

1. *Gifts*

Section 102 (excluding from gross income "the value of property acquired by gift, bequest, devise, or inheritance") and §1015 (prescribing the basis of property acquired by gift) carry forward the rules of §22(b)(3) and §113(a)(2) of the 1939 Code without substantive change, except for the addition of §1015(d) (taking account, in some circumstances, of federal gift tax paid on the transfer of donated property).

COMMISSIONER v. DUBERSTEIN
363 U.S. 278 (1960)

MR. JUSTICE BRENNAN delivered the opinion of the Court.

These two cases concern [§102(a)] which excludes from the gross income of an income taxpayer "the value of property acquired by gift." They pose the frequently recurrent question whether a specific transfer to a taxpayer in fact amounted to a "gift" to him within the meaning of the statute. The importance to decision of the facts of the cases requires that we state them in some detail.

No. 376, Commissioner v. Duberstein. The taxpayer, Duberstein, was president of the Duberstein Iron & Metal Company, a corporation with headquarters in Dayton, Ohio. For some years the taxpayer's company had done business with Mohawk Metal Corporation, whose headquarters were in New York City. The president of Mohawk was one Berman. The taxpayer and Berman had generally used the telephone to transact their companies' business with each other, which consisted of buying and selling metals. The taxpayer testified, without elaboration, that he knew Berman "personally" and had known him for about seven years. From time to time in their telephone conversations, Berman would ask

Duberstein whether the latter knew of potential customers for some of Mohawk's products in which Duberstein's company itself was not interested. Duberstein provided the names of potential customers for these items.

One day in 1951 Berman telephoned Duberstein and said that the information Duberstein had given him had proved so helpful that he wanted to give the latter a present. Duberstein stated that Berman owed him nothing. Berman said that he had a Cadillac as a gift for Duberstein, and that the latter should send to New York for it; Berman insisted that Duberstein accept the car, and the latter finally did so, protesting however that he had not intended to be compensated for the information. At the time Duberstein already had a Cadillac and an Oldsmobile, and felt that he did not need another car. Duberstein testified that he did not think Berman would have sent him the Cadillac if he had not furnished him with information about the customers. It appeared that Mohawk later deducted the value of the Cadillac as a business expense on its corporate income tax return.

Duberstein did not include the value of the Cadillac in gross income for 1951, deeming it a gift. The Commissioner asserted a deficiency for the car's value against him, and in proceedings to review the deficiency the Tax Court affirmed the Commissioner's determination. It said that "The record is significantly barren of evidence revealing any intention on the part of the payor to make a gift. . . . The only justifiable inference is that the automobile was intended by the payor to be remuneration for services rendered to it by Duberstein." The Court of Appeals for the Sixth Circuit reversed. 265 F.2d 28.

No. 546, Stanton v. United States. The taxpayer, Stanton, had been for approximately 10 years in the employ of Trinity Church in New York City. He was comptroller of the Church corporation, and president of a corporation, Trinity Operating Company, the church set up as a fully owned subsidiary to manage its real estate holdings, which were more extensive than simply the church property. His salary by the end of his employment there in 1942 amounted to $22,500 a year. Effective November 30, 1942, he resigned from both positions to go into business for himself. The Operating Company's directors, who seem to have included the rector and vestrymen of the church, passed the following resolution upon his resignation: "BE IT RESOLVED that in appreciation of the services rendered by Mr. Stanton . . . a gratuity is hereby awarded to him of Twenty Thousand Dollars, payable to him in equal instalments of Two Thousand Dollars at the end of each and every month commencing with the month of December, 1942; provided that, with the discontinuance of his services, the Corporation of Trinity Church is released from all rights and claims to pension and retirement benefits not already accrued up to November 30, 1942."

The Operating Company's action was later explained by one of its directors as based on the fact that, "Mr. Stanton was liked by all of the Vestry personally. He had a pleasing personality. He had come in when Trinity's affairs were in a difficult situation. He did a splendid piece of work, we felt. Besides that . . . he was liked by all of the members of the Vestry personally." And by another: "[W]e were all unanimous in wishing to make Mr. Stanton a gift. Mr. Stanton had loyally and faithfully served Trinity in a very difficult time. We thought of him in the highest regard. We understood that he was going in business for himself. We felt that he was entitled to that evidence of good will."

On the other hand, there was a suggestion of some ill-feeling between Stanton and the directors, arising out of the recent termination of the services of one Watkins, the Operating Company's treasurer, whose departure was evidently attended by some acrimony. At a special board meeting on October 28, 1942, Stanton had intervened on Watkins' side and asked reconsideration of the matter. The minutes reflect that "resentment was expressed as to the 'presumptuous' sug-

gestion that the action of the Board, taken after long deliberation, should be changed." The Board adhered to its determination that Watkins be separated from employment, giving him an opportunity to resign rather than be discharged. At another special meeting two days later it was revealed that Watkins had not resigned; the previous resolution terminating his services was then viewed as effective; and the Board voted the payment of six months' salary to Watkins in a resolution similar to that quoted in regard to Stanton, but which did not use the term "gratuity." At the meeting, Stanton announced that in order to avoid any such embarrassment or question at any time as to his willingness to resign if the Board desired, he was tendering his resignation. It was tabled, though not without dissent. The next week, on November 5, at another special meeting, Stanton again tendered his resignation which this time was accepted.

The "gratuity" was duly paid. So was a smaller one to Stanton's (and the Operating Company's) secretary, under a similar resolution, upon her resignation at the same time. The two corporations shared the expense of the payments. There was undisputed testimony that there were in fact no enforceable rights or claims to pension and retirement benefits which had not accrued at the time of the taxpayer's resignation, and that the last proviso of the resolution was inserted simply out of an abundance of caution. The taxpayer received in cash a refund of his contributions to the retirement plans, and there is no suggestion that he was entitled to more. He was required to perform no further services for Trinity after his resignation.

The Commissioner asserted a deficiency against the taxpayer after the latter had failed to include the payments in question in gross income. After payment of the deficiency and administrative rejection of a refund claim, the taxpayer sued the United States for a refund in the District Court for the Eastern District of New York. The trial judge, sitting without a jury, made the simple finding that the payments were a "gift," and judgment was entered for the taxpayer. The Court of Appeals for the Second Circuit reversed. 268 F.2d 727.

The Government, urging that clarification of the problem typified by these two cases was necessary, and that the approaches taken by the Courts of Appeals for the Second and the Sixth Circuits were in conflict, petitioned for certiorari in No. 376, and acquiesced in the taxpayer's petition in No. 546. On this basis, and because of the importance of the question in the administration of the income tax laws, we granted certiorari in both cases. 361 U.S. 923.

The exclusion of property acquired by gift from gross income under the federal income tax laws was made in the first income tax statute passed under the authority of the Sixteenth Amendment, and has been a feature of the income tax statutes ever since. The meaning of the term "gift" as applied to particular transfers has always been a matter of contention. Specific and illuminating legislative history on the point does not appear to exist. Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious. See Lockard v. Commissioner, 166 F.2d 409. The meaning of the statutory term has been shaped largely by the decisional law. With this, we turn to the contentions made by the Government in these cases.

First. The Government suggests that we promulgate a new "test" in this area to serve as a standard to be applied by the lower courts and by the Tax Court in dealing with the numerous cases that arise.[1] We reject this invitation. We are of opinion that the governing principles are necessarily general and have already been spelled out in the opinions of this Court, and that the problem is one which,

[1] The Government's proposed test is stated: "Gifts should be defined as transfers of property made for personal as distinguished from business reasons."

under the present statutory framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases. The cases at bar are fair examples of the settings in which the problem usually arises. They present situations in which payments have been made in a context with business overtones — an employer making a payment to a retiring employee; a businessman giving something of value to another businessman who has been of advantage to him in his business. In this context, we review the law as established by the prior cases here.

The course of decision here makes it plain that the statute does not use the term "gift" in the common-law sense, but in a more colloquial sense. This Court has indicated that a voluntary executed transfer of his property by one to another, without any consideration or compensation therefor, though a common-law gift, is not necessarily a "gift" within the meaning of the statute. For the Court has shown that the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift. Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 730. And, importantly, if the payment proceeds primarily from "the constraining force of any moral or legal duty," or from "the incentive of anticipated benefit" of an economic nature, Bogardus v. Commissioner, 302 U.S. 34, 41, it is not a gift. And, conversely, "[w]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." Robertson v. United States, 343 U.S. 711, 714.[2] A gift in the statutory sense, on the other hand, proceeds from a "detached and disinterested generosity," Commissioner v. LoBue, 351 U.S. 243, 246; "out of affection, respect, admiration, charity or like impulses." Robertson v. United States, supra, at 714. And in this regard, the most critical consideration, as the Court was agreed in the leading case here, is the transferor's "intention." Bogardus v. Commissioner, 302 U.S. 34, 43. "What controls is the intention with which payment, however voluntary, has been made." Id., at 45 (dissenting opinion).

The Government says that this "intention" of the transferor cannot mean what the cases on the common-law concept of gift call "donative intent." With that we are in agreement, for our decisions fully support this. Moreover, the *Bogardus* case itself makes it plain that the donor's characterization of his action is not determinative — that there must be an objective inquiry as to whether what is called a gift amounts to it in reality. 302 U.S. at 40. It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter.

It is suggested that the *Bogardus* criterion would be more apt if rephrased in terms of "motive" rather than "intention." We must confess to some skepticism as to whether such a verbal mutation would be of any practical consequence. We take it that the proper criterion, established by decision here, is one that inquires what the basic reason for his conduct was in fact — the dominant reason that explains his action in making the transfer. Further than that we do not think it profitable to go.

Second. The Government's proposed "test," while apparently simple and precise in its formulation, depends frankly on a set of "principles" or "presumptions" derived from the decided cases, and concededly subject to various exceptions; and it involves various corollaries, which add to its detail. Were we to promulgate this test as a matter of law, and accept with it its various presuppositions and stated consequences, we would be passing far beyond the requirements of the cases before us, and would be painting on a large canvas with indeed a broad

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2 The cases including "tips" in gross income are classic examples of this. See, e.g., Roberts v. Commissioner, 176 F.2d 221.

brush. The Government derives its test from such propositions as the following: That payments by an employer to an employee, even though voluntary, ought, by and large, to be taxable; that the concept of a gift is inconsistent with a payment's being a deductible business expense; that a gift involves "personal" elements; that a business corporation cannot properly make a gift of its assets. The Government admits that there are exceptions and qualifications to these propositions. We think, to the extent they are correct, that these propositions are not principles of law but rather maxims of experience that the tribunals which have tried the facts of cases in this area have enunciated in explaining their factual determinations. Some of them simply represent truisms: it doubtless is, statistically speaking, the exceptional payment by an employer to an employee that amounts to a gift. Others are overstatements of possible evidentiary inferences relevant to a factual determination on the totality of circumstances in the case: it is doubtless relevant to the over-all inference that the transferor treats a payment as a business deduction, or that the transferor is a corporate entity. But these inferences cannot be stated in absolute terms. Neither factor is a shibboleth. The taxing statute does not make nondeductibility by the transferor a condition on the "gift" exclusion; nor does it draw any distinction, in terms, between transfers by corporations and individuals, as to the availability of the "gift" exclusion to the transferee. The conclusion whether a transfer amounts to a "gift" is one that must be reached on consideration of all the factors.

Specifically, the trier of fact must be careful not to allow trial of the issue whether the receipt of a specific payment is a gift to turn into a trial of the tax liability, or of the propriety, as a matter of fiduciary or corporate law, attaching to the conduct of someone else. The major corollary to the Government's suggested "test" is that, as an ordinary matter, a payment by a corporation cannot be a gift, and, more specifically, there can be no such thing as a "gift" made by a corporation which would allow it to take a deduction for an ordinary and necessary business expense. As we have said, we find no basis for such a conclusion in the statute; and if it were applied as a determinative rule of "law," it would force the tribunals trying tax cases involving the donee's liability into elaborate inquiries into the local law of corporations or into the peripheral deductibility of payments as business expenses. The former issue might make the tax tribunals the most frequent investigators of an important and difficult issue of the laws of the several States, and the latter inquiry would summon one difficult and delicate problem of federal tax law as an aid to the solution of another. Or perhaps there would be required a trial of the vexed issue whether there was a "constructive" distribution of corporate property, for income tax purposes, to the corporate agents who had sponsored the transfer. These considerations, also, reinforce us in our conclusion that while the principles urged by the Government may, in nonabsolute form as crystallizations of experience, prove persuasive to the trier of facts in a particular case, neither they, nor any more detailed statement than has been made, can be laid down as a matter of law.

Third. Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact. . . .

This conclusion may not satisfy an academic desire for tidiness, symmetry and precision in this area, any more than a system based on the determinations of

various fact-finders ordinarily does. But we see it as implicit in the present statutory treatment of the exclusion for gifts, and in the variety of forums in which federal income tax cases can be tried. If there is fear of undue uncertainty or overmuch litigation, Congress may make more precise its treatment of the matter by singling out certain factors and making them determinative of the matter, as it has done in one field of the "gift" exclusion's former application, that of prizes and awards.[3] Doubtless diversity of result will tend to be lessened somewhat since federal income tax decisions, even those in tribunals of first instance turning on issues of fact, tend to be reported, and since there may be a natural tendency of professional triers of fact to follow one another's determinations, even as to factual matters. But the question here remains basically one of fact, for determination on a case-by-case basis.

One consequence of this is that appellate review of determinations in this field must be quite restricted. Where a jury has tried the matter upon correct instructions, the only inquiry is whether it cannot be said that reasonable men could reach differing conclusions on the issue. Baker v. Texas & Pacific R. Co., 359 U.S. at 228. Where the trial has been by a judge without a jury, the judge's findings must stand unless "clearly erroneous." Fed. Rules Civ. Proc., 52(a). . . .

Fourth. A majority of the Court is in accord with the principles just outlined. And, applying them to the *Duberstein* case, we are in agreement, on the evidence we have set forth, that it cannot be said that the conclusion of the Tax Court was "clearly erroneous." It seems to us plain that as trier of the facts it was warranted in concluding that despite the characterization of the transfer of the Cadillac by the parties and the absence of any obligation, even of a moral nature, to make it, it was at bottom a recompense for Duberstein's past services, or an inducement for him to be of further service in the future. We cannot say with the Court of Appeals that such a conclusion was "mere suspicion" on the Tax Court's part. To us it appears based in the sort of informed experience with human affairs that fact-finding tribunals should bring to this task.

As to *Stanton,* we are in disagreement. To four of us, it is critical here that the District Court as trier of fact made only the simple and unelaborated finding that the transfer in question was a "gift." To be sure, conciseness is to be strived for, and prolixity avoided, in findings; but, to the four of us, there comes a point where findings become so sparse and conclusory as to give no revelation of what the District Court's concept of the determining facts and legal standard may be. See Matton Oil Transfer Corp. v. The Dynamic, 123 F.2d 999, 1000-1001. Such conclusory, general findings do not constitute compliance with Rule 52's direction to "find the facts specially and state separately . . . conclusions of law thereon." While the standard of law in this area is not a complex one, we four think the unelaborated finding of ultimate fact here cannot stand as a fulfillment of these requirements. It affords the reviewing court not the semblance of an indication of the legal standard with which the trier of fact has approached his task. For all that appears, the District Court may have viewed the form of the resolution or the simple absence of legal consideration as conclusive. While the judgment of the Court of Appeals cannot stand, the four of us think there must be further proceedings in the District Court looking toward new and adequate findings of fact. In this, we are joined by MR. JUSTICE WHITTAKER, who agrees that the find-

[3] I.R.C., §74, which is a provision new with the 1954 Code. Previously, there had been holdings that such receipts as the "Pot O' Gold" radio giveaway, Washburn v. Commissioner, 5 T.C. 1333, and the Ross Essay Prize, McDermott v. Commissioner, 80 U.S. App. D.C. 176, 150 F.2d 585, were "gifts." Congress intended to obviate such rulings. S. Rep. No. 1622, 83d Cong., 2d Sess., p. 178. We imply no approval of those holdings under the general standard of the "gift" exclusion. Cf. Robertson v. United States, supra.

ings were inadequate, although he does not concur generally in this opinion.

Accordingly, in No. 376, the judgment of this Court is that the judgment of the Court of Appeals is reversed, and in No. 546, that the judgment of the Court of Appeals is vacated, and the case is remanded to the District Court for further proceedings not inconsistent with this opinion.

It is so ordered.

MR. JUSTICE HARLAN concurs in the result in No. 376. In No. 546, he would affirm the judgment of the Court of Appeals for the reasons stated by MR. JUSTICE FRANKFURTER.

MR. JUSTICE WHITTAKER, agreeing with *Bogardus* that whether a particular transfer is or is not a "gift" may involve "a mixed question of law and fact," 302 U.S., at 39, concurs only in the result of this opinion.

MR. JUSTICE DOUGLAS dissents, since he is of the view that in each of these two cases there was a gift under the test which the Court fashioned nearly a quarter of a century ago in Bogardus v. Commissioner, 302 U.S. 34.

[Mr. Justice Black concurred in *Duberstein* and dissented in *Stanton,* on the ground that the trial court's finding in each case was "not clearly erroneous."

Mr. Justice Frankfurter said that "in the two situations now before us the business implications are so forceful that I would apply a presumptive rule placing the burden upon the beneficiary to prove the payment wholly unrelated to his services to the enterprise" and that the Court's emphasis on the fact-finding tribunal's "experience with the mainsprings of human conduct" would set them "to sail on an illimitable ocean of individual beliefs and experiences." He concluded that *Duberstein* was properly taxed, and that Stanton's payment should have been taxed because it was not "sheer benevolence but in the nature of a generous lagniappe, something extra thrown in for services received though not legally nor morally required to be given."]

NOTE

1. *Remand of Stanton case.* On the remand of the *Stanton* case, the District Court made detailed findings of fact and again concluded that the payments to Stanton were gifts. On appeal, the Court of Appeals affirmed on the ground that the findings were not "clearly erroneous," Chief Judge Lumbard concurring because of the restricted character of appellate review although he thought a contrary inference should have been drawn from the "undisputed basic facts." 287 F.2d 876 (2d Cir. 1961).

In Pellar v. Commissioner, 25 T.C. 299 (1955), the Commissioner asserted that the difference between the contract price paid by the taxpayer for a house constructed for him and its fair market value was taxable as income. This difference resulted from the fact that the construction company did not include a profit in its calculation of the contract price and, in addition, did not charge for a number of "extras" ordered by the taxpayer during construction; this generosity was attributable to the contractor's desire to preserve and enhance his friendship with the taxpayer's father-in-law, who controlled a large amount of industrial construction business. The court held that the difference was not taxable income and that the *Glenshaw Glass Co.* case, upon which the Commissioner relied, was distinguishable because "it involved the taxation of exemplary damages for fraud and punitive treble damages for antitrust violations." Would the *Duberstein* case require a different result?

See the comments of Dean Griswold on *Duberstein* in his Forward: Of Time and Attitudes — Professor Hart and Judge Arnold, 74 Harv. L. Rev. 81, 88-91 (1960); see also Rothschild, Business Gifts as Income, 19 N.Y.U. Inst. on Fed. Taxation 147 (1961).

2. *Christmas "gifts."* Regs. §1.61-2(a)(1) provides that Christmas bonuses are taxable as compensation. Can an employer make a Christmas "gift" to his employees? In Rev. Rul. 59-58, 1959-1 C.B. 17, the Internal Revenue Service announced a "no income if you can eat it or drink it" doctrine:

It is . . . held that the value of a turkey, ham, or other item of merchandise of similar nominal value, distributed by an employer to an employee at Christmas, or a comparable holiday, as part of a general distribution to employees engaged in the business of the employer as a means of promoting their good will, does not constitute wages subject to income tax withholding or wages for Federal Insurance Contributions Act or Federal Unemployment Tax Act purposes.

In view of the small amounts involved, and since it may reasonably be contended in many cases that such items constitute excludable gifts, it is similarly held that the value of such an item of merchandise need not be treated as taxable income by the employee who receives it.

The foregoing rules will not apply to distributions of cash, gift certificates, and similar items of readily convertible cash value, regardless of the amount involved.

It is further held that the cost to the employer of turkeys, hams, and other merchandise of similar nominal value which are distributed generally to the employees engaged in his business, primarily for the business purpose of promoting good relations with his employees, is deductible by the employer under section 162 of the Code as an ordinary and necessary business expense.

See also Rev. Rul. 131, 1953-2 C.B. 112, stating that amounts contributed by an employer for the rehabilitation of its employees who suffered personal injuries and property damages as the result of a tornado do not constitute taxable income to the employees, the payments being measured by need rather than by services rendered or length of service.

3. *May the donor deduct the cost of his "gifts"?* Note that the Christmas turkey ruling quoted in the preceding paragraph acknowledges that the employer may deduct the cost of a gift as a business expense under §162 even though the recipient is entitled to exclude it from income under §102, a point that is also touched on by the *Duberstein* opinion. In 1962, however, §274(b) was added to the Code to limit the deductibility of business gifts to a maximum of $25 per recipient per year. (See p. 234 infra.) Is this limitation, which embraces "any item excludable from gross income of the recipient under section 102 which is not excludable from his gross income under any other provision," applicable to the rehabilitation payments described in Rev. Rul. 131, cited in the preceding paragraph?

4. *Other business "gifts."* For another area in which taxpayers have argued that a "gift" under §102 is possible in a business context, see Bradford v. Commissioner, supra page 89; see also Capital Coal Corp. v. Commissioner, 250 F.2d 361 (2d Cir. 1957), taxing a cancellation of debt and saying that "a gift . . . would be a most unusual occurrence when made by a company engaged in operating a business for profit."

Suppose the taxpayer is urged by an advertisement to use a tube of toothpaste for one month, on condition that he can keep the tube and get his money back if not entirely satisfied. If he gets his money back, does he realize income? What if he gets double his money back?

5. *The status of tips.* Note the Court's reference (footnote 2) to the *Roberts* case, holding that the tips received by a taxi driver were includible in his gross income. Because many waiters, taxi drivers, etc., fail to keep accurate records of this source of income, the Internal Revenue Service often estimates the amount received by indirect methods, e.g., by determining the total dollar amount of food and drink served by a waiter from the restaurant's records and assuming that his tips equal 10 per cent of this amount. See page 892 infra. In United States v. McCormick, 67 F.2d 867 (2d Cir. 1933), it was held that "contributions" received by a city clerk after marriage ceremonies from bridegrooms who were fearful of being accused of stinginess were taxable; and see Regs. §1.61-2(a)(1), to the effect that "marriage fees and other contributions received by a clergyman for services" are taxable. Does this mean that the groom cannot make a "gift" to the clergyman?

See also Miller v. Commissioner, 327 F.2d 846 (2d Cir. 1964) (distributions from a Christmas Fund contributed by members of a club for its employees held taxable).

Does a professional beggar realize taxable income? What if he "sells" for 10 cents each pencils that are normally sold for 5 cents? See Webber v. Commissioner, 219 F.2d 834 (10th Cir. 1955) (minister conducting nonsectarian religious programs by radio held taxable on amounts received in response to solicitation; although amounts were larger during months of taxpayer's birthday and wedding anniversary, there was "no evidence tending

to show that the contributions were referred to [by the contributors] as gifts; or that any of the contributors knew the petitioners personally or had any personal relationship with them which would form the basis for personal gifts as distinguished from contributions to the perpetuation of the programs which the contributors enjoyed and desired to financially support").

6. *Diamonds are a girl's best friend.* Does a young lady realize taxable income if she receives presents of property or cash from an admirer or is supported by him? What if she has a number of admirers, either successively or simultaneously? The following is from the New Haven Sunday Register for March 8, 1953:

> BRUNETTE HELD ON TAX CHARGES; SELDOM WORKED
>
> Birmingham, Ala. March 7 — (AP) — A pretty, 32-year-old brunette, who said, "I entertained guys," was charged with failing to file income tax returns on an income of almost $50,000.
>
> Miss Jessie Ruth Chesnutt was arraigned before U.S. Commissioner Louise O. Carlton yesterday and released under $500 bond.
>
> Her attorney, Robert Gwin, contended "that Miss Chesnutt's income is not taxable in that the money she has was given to her in the form of gifts."
>
> He later told reporters the funds "were given her by various individuals over a period of years."
>
> Asked if the gifts were from men or women, Miss Chesnutt said: "Gentlemen, naturally."
>
> "I never did any kind of work much," she continued. "I did work in a cotton mill and on a farm and I entertained guys."
>
> Miss Chesnutt said she was a native of Gadsden, Ala., and had also lived in Las Vegas, Reno and Detroit.
>
> A Federal warrant against her charged she failed to file income tax returns on an income of $11,985 in 1949, $25,644 in 1950 and $12,144 in 1951.
>
> The Government filed an $83,000 tax lien against Miss Chesnutt's property. Gwin said $60,000 of her property was in defense bonds.
>
> The solicitor's office here said Miss Chesnutt has been arrested three times on disorderly conduct charges.

See Brizendine v. Commissioner, ¶57,032 P-H Memo T.C. (payments to taxpayer for forbearing from prostitution and granting "her companionship" to payor held taxable); Blevins v. Commissioner, ¶55,211 P-H Memo T.C. (payments from an admirer, which both he and the taxpayer testified were "gifts in contemplation of marriage," held taxable; since he was married and there was no evidence that either he or his wife attempted to get a divorce, court rejected taxpayer's claim for want of proof).

7. *Rewards as gifts.* If a fond and abstemious uncle promises his nephew $5000 if he neither drinks nor smokes before the age of 21, will the payment be income to the nephew?

8. *Strike benefits: the Kaiser case.* In United States v. Kaiser, 363 U.S. 299 (1960), decided on the same day as *Duberstein,* the Supreme Court affirmed a judgment, based on a jury verdict, holding that strike assistance received by a striker from a union of which he was not a member was a "gift" within the meaning of §102(a). An opinion by Mr. Justice Brennan, in which the Chief Justice, Mr. Justice Black, and Mr. Justice Douglas joined, stated:

> The factual inferences to be drawn from the basic facts were here for the jury. They had the power to conclude, on the record, taking into account such factors as the form and amount of the assistance and the conditions of personal need, of lack of other sources of income, compensation, or public assistance, and of dependency status, which surrounded the program under which it was rendered, that while the assistance was furnished only to strikers, it was not a recompense for striking. They could have concluded that the very general language of the Union's constitution, when considered with the nature of the Union as an entity and with the factors to which we have just referred, did not indicate that basically the assistance proceeded from any constraint of moral or legal obligation, of a nature that would preclude it from being a gift. And on all these circumstances, the jury could have concluded that assistance,

rendered as it was to a class of persons in the community in economic need, proceeded primarily from generosity or charity, rather than from the incentive of anticipated economic benefit. We can hardly say that, as a matter of law, the fact that these transfers were made to one having a sympathetic interest with the giver prevents them from being a gift. This is present in many cases of the most unquestionable charity. [363 U.S. at 304.]

Justices Frankfurter and Clark concurred in the result, primarily on the ground that there was evidence that "at the time these benefits were paid, the union had assumed the functions normally exercised by private charitable organizations and governmental relief programs, in view of the excessive difficulty in getting adequate relief from them, so that these benefits were dispensed pursuant to such a charitable relief program in what, because of the strike, was a distressed area" and that "in making these payments the union was exercising a wholly charitable function." Before arriving at this conclusion, Mr. Justice Frankfurter discussed at length a series of rulings by the Internal Revenue Service from which the taxpayer had sought to derive a binding administrative policy of exempting "subsistence relief," and concluded that there was a rational basis for the earlier rulings that was not applicable to the strike benefits before the Court, with the result that the Internal Revenue Service was not denying "equal treatment" in ruling that the benefits were taxable. (So far, at least, there has been virtually no judicial development of the taxpayer's "equal treatment" theory; see pages 916-920 infra.) Although Mr. Justice Douglas joined in Mr. Justice Brennan's opinion, he also filed a separate concurrence, expressing the view that a motion by the taxpayer for a directed verdict would have been in order and should have been granted; since "only the needy got the relief," the payments "were welfare, plain and simple." By contrast, Justices Whittaker, Harlan, and Stewart dissented, concluding that the payments "were made by the union to enable and encourage respondent and other striking workers to continue the strike which had been called or approved by the union, and were not motivated by benevolence." The dissenting Justices rejected Mr. Justice Frankfurter's "charitable agency" theory: "The motivation of a public welfare agency in supplying basic needs to the unemployed is purely charitable in nature, but payments by a private union to striking workers to enable them to continue to successful conclusion a strike called or approved by the union, cannot reasonably be said to have proceeded primarily from any such charitable impulse." 363 U.S. at 332.

In Rev. Rul. 61-136, 1961-2 C.B. 20, the Internal Revenue Service stated that in cases presenting facts substantially like those in *Kaiser*, it will regard strike benefit payments as "gifts" and that other cases will be scrutinized to determine whether the payments will be treated as taxable income, but "the fact that strike benefits are paid only to union members will not, in and of itself, be considered determinative" of taxability.

9. *Reference*. Klein, An Enigma in the Federal Income Tax: The Meaning of the Word "Gift," 48 Minn. L. Rev. 215 (1963).

POYNER v. COMMISSIONER

301 F.2d 287 (4th Cir. 1962)

Before SOBELOFF, Chief Judge, and SOPER and J. SPENCER BELL, Circuit Judges.

SOBELOFF, Chief Judge.

Not the least of the difficulties often faced by a recently widowed woman is the loss of her husband's financial support. However, for many widows of ranking employees in companies, this cause for worry has been alleviated by the practice of the employer making payments to the widow for limited periods following the husband's death, frequently by continuing to pay her the salary her husband would have received had he lived. The Commissioner of Internal Revenue has since 1950 sought to treat such payments as ordinary income to the widow under the general provisions of section 61 of the Internal Revenue Code. The widows, on the other hand, have contended with considerable success in the courts that

the payments were gifts, hence not includible in gross income under section 102. The issue in the present case is of this character. We are asked by a widow to reverse a decision of the Tax Court which treats as ordinary income the payments made to her by a corporation of which for 38 years her husband had been president and majority stockholder.

The statutory definition of a "gift" which is excluded from a person's gross income by section 102 and the function of an appellate court in reviewing the findings of the trier of fact in these cases have recently received extensive attention by the Supreme Court. Commissioner v. Duberstein. A study of this decision indicates that in any given case there are three steps which must be followed in reaching a conclusion. First, the trier of fact must make findings as to the basic facts, the actual happenings. These findings may not be upset if found by a jury unless the reviewing court is convinced that reasonable men could make only contrary findings, or, if found by a judge without a jury, unless clearly erroneous.

Second, the trier of fact must draw from these basic findings his inferences as to the "dominant reason" for the payments — the answer to the question why the payments were made. This determination too is one of fact as to which appellate review is restricted to the clearly erroneous standard where, as in the present case, a judge sat without a jury. The scope of review is therefore limited to ascertaining whether the trier of fact considered the correct criteria in making the factual inferences and whether the finding as to dominant motive is sufficiently supported in the evidence.

Third, the lower court must decide whether the dominant reason, as found, for the payments is such as to require gift treatment and an escape from taxation under section 102, or income treatment and taxation under section 61. This question, involving the proper meaning of the statutory term "gift," is one of law as to which an appellate court may make an independent judgment. To give guidance in the decision of future cases, the majority opinion in *Duberstein* summarized earlier cases, citing specific examples of motives which require as a matter of law either the conclusion that the payments are a gift or that they are income, as those terms are used in the Internal Revenue Code.

Now we shall see how this three-stage approach was followed in the case before us. The basic facts are undisputed since the parties submitted the case to the Tax Court upon stipulation. Over a span of 38 years before his death on January 31, 1956, Mervin G. Pierpont, the taxpayer's husband, served as the president of the Loewy Drug Company, a wholesale drug distributor in Baltimore. Throughout the entire period, he owned two-thirds of the outstanding stock, the rest being owned by Morton L. Lazarus. The company had paid him all amounts owed for his services. On March 22, 1956, the Board of Directors of the company passed a resolution whereby a 1954 Cadillac, valued at $3,245.14, was transferred to his widow. The resolution stated that "in recognition of the services rendered by the late Mervin G. Pierpont, this Corporation pay to his widow as a continuance of his salary the sum of Three Thousand, Two Hundred Forty-Five Dollars and Fourteen Cents . . ." By a similar resolution passed the following month, the company undertook to pay his widow $600 per month either until the payments aggregated $20,000 or until further action by the Board. She received under the two resolutions a total of $9,910.05 in 1956 and $7,800.00 in 1957 when the payments were terminated upon the liquidation of the company. It was stipulated in the Tax Court that the payments were "not made pursuant to any contract, plan, policy, practice, or understanding made or in effect prior to the Decedent's death." However, there is no mention in the stipulation as to who were the di-

rectors who authorized the payments and what were their relationships to the widow; neither are we told to whom Pierpont devised his controlling interest in the company, or what the widow's personal financial status may have been.

In her 1956 tax return the widow reported as a gift the $9,910.05 received in that year. The Commissioner, however, determined that it was income to her, applied the $5,000 exclusion provided for employee death benefits by section 101(b),* and asserted a tax deficiency of $1,376.22 on the remaining $4,910.05. The sums paid the widow had been fully deducted by the company as an expense of doing business.

From the stipulated facts, the Tax Court proceeded to draw factual inferences as to motive. Referring to the two corporate resolutions which authorized the payments, the Tax Court said that they "suggest that the dominant intention of the donor was to pay additional compensation in respect of the decedent's services." In addition, the court found that there was "nothing in the record that would lead us to conclude that the alleged gifts 'proceed[ed] from a detached and disinterested generosity . . . out of affection, respect, admiration, charity or like impulses,' " motives which the Supreme Court recognized in *Duberstein* as indicating gift treatment. The Tax Court then summarized its findings and conclusions by saying that "the payments in controversy were not intended as a 'gift,' " and treated them as income.

We think that the findings of the Tax Court regarding the dominant reason for the payments, based as they are upon the stipulated facts, cannot be sustained. The decisions in the Tax Court prior to the *Duberstein* case established a set of factors to be evaluated in discovering the dominant motive for such payments to widows, and our decision in Bounds v. United States, 262 F.2d 876 (4th Cir. 1958), recognized and followed these criteria. The clearest formulation appears in Florence S. Luntz, 29 T.C. 647, 650 (1958), where the Tax Court listed the following as the five factors to be considered:

> (1) the payments had been made to the wife of the deceased employee and not to his estate; (2) there was no obligation on the part of the corporation to pay any additional compensation to the deceased employee; (3) the corporation derived no benefit from the payment; (4) the wife of the deceased employee performed no services for the corporation; and (5) the services of her husband had been fully compensated.

The stipulated facts directly respond to every one of the five factors, and in each instance the response is favorable to the widow. This being so, we see no justification for the Tax Court's finding that "there is no solid evidence that they [the directors authorizing the payments] were motivated in any part by the widow's needs or by a sense of generosity or the like." In every prior Tax Court case, essentially identical facts were held sufficient to support the conclusion that the dominant motive was sympathy for the taxpayer's widowed position. The only evidence on which the Tax Court specifically relies for its contrary finding is the wording of the authorizing corporate resolutions. While the language of the resolutions certainly merits consideration, never before has such language been deemed sufficient by itself, and in the face of the other above specified factors, to support a finding that the payments were compensation for services rendered. As the facts stipulated in this case do not differ from those deemed conclusive in past cases, a contrary finding seems to us without warrant.

The Supreme Court in *Duberstein* did not destroy the authority of the earlier Tax Court cases and the guides enunciated in them for discovering motivation. The plea addressed by the Government to the Supreme Court in *Duberstein* to establish a new test defining "gift" was expressly rejected. The Court limited itself

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* See Note following this case. — Ed.

to summarizing earlier decisions as to which particular dominant motivations, when adequately supported by the evidence, result in income treatment, and which result in gift treatment. An enumeration of the criteria, by which the trier of fact shall determine in every type of case what that dominant reason is, was deemed inadvisable, if not futile. The Court preferred to leave the development of such criteria to a case-by-case approach in the lower courts.

On the other hand, *Duberstein* cannot be read as limiting inquiry by the trier of fact solely to the factors recognized by the earlier decisions. The objective is to discover which motive is dominant in a field of co-existing motives. In the task of sorting out the varying motives, the development of more reliable criteria by the triers of fact should not be curtailed. Indeed, the Tax Court since *Duberstein* has considered it necessary to inquire into the widow's stock holdings in the company and the knowledge or lack of it on the part of the Board of her financial status following the death of her husband. The Tax Court in the present case also seems to have thought that the directors' knowledge of "the widow's needs" was an important factor. These subjects are certainly relevant, and inquiry may properly be directed to them, and whatever other factors the trier of fact might think helpful.

Nevertheless, none of the facts stipulated in the present case touches upon those additional factors which since *Duberstein* have been important. The stipulations were made before *Duberstein* and covered only the criteria which had up to that time been formulated and treated by the Tax Court and this circuit as decisive. It would be unfair now to allow findings to stand, which are adverse to the taxpayer because of her silence on matters never deemed pertinent in earlier litigation. While, as we have indicated, it is perfectly proper for the court to broaden the field of inquiry beyond that previously established, this should not be done without affording an opportunity to the taxpayer, and to the Government as well, to amplify the record. Of course, we do not undertake to dictate the result to be reached upon the broadened inquiry. Additional data which the parties will be free to produce may have the effect of confirming or overcoming the result which the five *Luntz* factors, standing alone, were held to require in the earlier cases.

Decision vacated and case remanded for proceedings not inconsistent with this opinion.

NOTE

1. *Exclusion of "employee death benefits" by §101(b).* This much-litigated issue has declined somewhat in importance, since in 1951 the Code was amended to provide that "employee death benefits" (i.e., amounts paid by an employer to the beneficiaries or the estate of a deceased employee, not in excess of $5000) shall be excluded from taxable income. §101(b). The exclusion is not applicable to amounts that the employee could have received during his life, unless paid under a qualified pension, stock bonus, or profit-sharing plan.

As originally enacted, this exclusion was applicable only to amounts paid pursuant to a contract, and the exclusion was apparently granted on the theory that such death benefits are analogous to the proceeds of life insurance, which are receivable tax-free by the beneficiaries of the insured (infra p. 147). (There is, however, this distinction: the premiums paid for the life insurance will have come out of the insured's taxable income, whereas the employee death benefit will not have given rise to any income taxable to the employee during his lifetime.) But in 1954, the requirement of a contractual obligation was eliminated, with the result that payments made voluntarily by the employer qualify—up to the $5000 limit.

In the *Pierpont* case, the Internal Revenue Service allowed an exclusion under §101(b) for the first $5000 received by the widow, and contended before the Tax Court that the

enactment of §101(b) impliedly closed the §102 (gift) route to tax exemption for the excess above $5000. Since the Tax Court held that the payment was not a gift, it did not have to decide whether §102 remains available to recipients of employee death benefits, a question on which there is a split of authority. Compare Reed v. United States, 177 F. Supp. 205 (W.D. Ky. 1959), aff'd per curiam, 277 F.2d 456 (6th Cir. 1960) (§102 remains available as an alternate route to exclusion), with Bounds v. United States, 262 F.2d 876 (4th Cir. 1958) (dictum, contra). The government did not press this point on appeal, and the Internal Revenue Service has announced that hereafter it will argue that the 1954 extension of §101(b) to non-contractual payments was an endorsement of its view that widows' payments are "generally" not gifts, but that it will no longer contend that §101(b) automatically bars recourse to §102. Rev. Rul. 62-102, 1962-2 C.B. 37.

2. *Payments by closely held corporations.* If the widow owns a controlling stock interest in the corporation when the payment is made, how are the *Duberstein* factors of "detached and disinterested generosity" and "affection, respect, admiration, charity, or like impulses" to be tested? If the widow owns all the stock, can she urge that the payment is a gift because charity begins at home — or is a payment under such circumstances to be viewed as a disguised (and taxable) dividend? Can the $5000 exclusion of §101(b) be denied if the widow owns all of the stock on the ground that the payment is "really" a dividend rather than an amount "paid by or on behalf of an employer . . . by reason of the death of the employee"?

See Bacon v. United States, — F. Supp. — (E.D. Ky. 1963) (payments to widow of controlling shareholder; held, taxable as dividends).

3. *Effect of a plan for paying death benefits.* Assuming that the first few widows to whom payments are made by a single employer succeed in excluding them as gifts, will reliance on §102 become increasingly difficult as the company's employees come to expect that their widows will be similarly treated?

4. *The employer's right to deduct death benefits.* Before 1962, most employers probably deducted employee death benefits as business expenses under §162, whether the recipients claimed an exclusion under §102 or not. Fifth Ave. Coach Lines, Inc. v. Commissioner, 31 T.C. 1080, 1092 (1959), rev'd (other issues), 281 F.2d 556 (2d Cir. 1960). But the enactment in 1962 of §274(b), limiting the employer's deduction for business gifts to $25, may discourage payments in excess of $5000. See Regs. §1.274-3(b) (deduction limited to amounts that qualify under §101(b) for exclusion in hands of recipient). If the employer is willing to pay a larger amount only if a business deduction will be permissible, what steps can it take to avoid the $25 limit of §274(b) — and what effect will these steps have on the employee's widow or other heirs?

See generally Baird, Taxability of Payments to Widows of Deceased Employees, 1963 So. Calif. Tax Inst. 775; Note, Payments to Widows of Corporate Executives and Employees, 49 Va. L. Rev. 74 (1963).

5. *Pensions.* According to Regs. §1.61-11(a), "[p]ensions and retirement allowances paid either by the Government or by private persons constitute gross income unless excluded by law." Can a pension received by a retired employee qualify for the exclusion accorded to "gifts" by §102(a)? See Peters v. Smith, 221 F.2d 721 (3d Cir. 1955) ("employer in providing the questioned payments did not indicate unequivocally whether such action was intended as additional compensation for past services, or merely as an expression of a philanthropic attitude, or as a bid for employee good will"; held, exclusion as a gift is a jury issue).

6. *Clergymen.* After losing a series of cases on the taxability of pensions and other payments received by retired clergymen from their congregations, the Internal Revenue Service ruled in 1955 that it would not continue to litigate similar cases:

> In the cited cases the payments were not made in accordance with any enforceable agreement, established plan, or past practice; the recipient did not undertake to perform any further services for the congregation and was not expected to do so; there was a far closer personal relationship between the recipient and the congregation than is found in lay employment relationships; and the available evidence indicated that the amount paid was determined in the light of the financial position of the congrega-

tion and the needs of the recipient, who had been adequately compensated for his past services.

The decisions in the cited cases, to the effect that the amounts involved were exempt gifts rather than taxable income, are accepted by the Service on their particular facts. In other cases involving payments to retired ministers or rabbis under similar circumstances the amounts paid will accordingly be treated as gifts excludable from gross income under section 102 of the 1954 Code. [Rev. Rul. 55-422, 1955-1 C.B. 14.]

In Perkins v. Commissioner, 34 T.C. 117 (1960), the Tax Court held that a pension paid under a large-scale plan of the Baltimore Conference of the Methodist Church was taxable: "the pension payments were made in accordance with the established plan and past practice of The Methodist Church, there was no close personal relationship between the [taxpayer] and the bulk of the contributing congregations, and the amounts paid were not determined in the light of the needs of the individual recipients."

Is the litigation policy announced by Rev. Rul. 55-422 consistent with the *Duberstein* case? With the "no establishment of religion" clause of the First Amendment?

FARID-ES-SULTANEH v. COMMISSIONER

160 F.2d 812 (2d Cir. 1947)

Before SWAN, CHASE, and CLARK, Circuit Judges.

CHASE, Circuit Judge.

The problem presented by this petition is to fix the cost basis to be used by the petitioner in determining the taxable gain on a sale she made in 1938 of shares of corporate stock. She contends that it is the adjusted value of the shares at the date she acquired them because her acquisition was by purchase. The Commissioner's position is that she must use the adjusted cost basis of her transferor because her acquisition was by gift. The Tax Court agreed with the Commissioner and redetermined the deficiency accordingly.

The pertinent facts are not in dispute and were found by the Tax Court as they were disclosed in the stipulation of the parties substantially as follows:

The petitioner is an American citizen who filed her income tax return for the calendar year 1938 with the Collector of Internal Revenue for the Third District of New York and in it reported sales during that year of 12,000 shares of the common stock of the S. S. Kresge Company at varying prices per share, for the total sum of $230,802.36 which admittedly was in excess of their cost to her. How much this excess amounted to for tax purposes depends upon the legal significance of the facts now to be stated.

In December 1923 when the petitioner, then unmarried, and S. S. Kresge, then married, were contemplating their future marriage, he delivered to her 700 shares of the common stock of the S. S. Kresge Company which then had a fair market value of $290 per share. The shares were all in street form and were to be held by the petitioner "for her benefit and protection in the event that the said Kresge should die prior to the contemplated marriage between the petitioner and said Kresge." The latter was divorced from his wife on January 9, 1924, and on or about January 23, 1924 he delivered to the petitioner 1800 additional common shares of S. S. Kresge Company which were also in street form and were to be held by the petitioner for the same purposes as were the first 700 shares he had delivered to her. On April 24, 1924, and when the petitioner still retained the possession of the stock so delivered to her, she and Mr. Kresge executed a written ante-nuptial agreement wherein she acknowledged the receipt of the shares "as a gift made by the said Sebastian S. Kresge, pursuant to this indenture, and as an

ante-nuptial settlement, and in consideration of said gift and said ante-nuptial settlement, in consideration of the promise of said Sebastian S. Kresge to marry her, and in further consideration of the consummation of said promised marriage" she released all dower and other marital rights, including the right to her support to which she otherwise would have been entitled as a matter of law when she became his wife. They were married in New York immediately after the ante-nuptial agreement was executed and continued to be husband and wife until the petitioner obtained a final decree of absolute divorce from him on, or about, May 18, 1928. No alimony was claimed by, or awarded to, her.

The stock so obtained by the petitioner from Mr. Kresge had a fair market value of $315 per share on April 24, 1924, and of $330 per share on or about May 6, 1924, when it was transferred to her on the books of the corporation. She held all of it for about three years, but how much she continued to hold thereafter is not disclosed except as that may be shown by her sales in 1938. Meanwhile her holdings had been increased by a stock dividend of 50 per cent, declared on April 1, 1925; one of 10 to 1 declared on January 19, 1926; and one of 50 per cent, declared on March 1, 1929. Her adjusted basis for the stock she sold in 1938 was $10.66⅔ per share computed on the basis of the fair market value of the shares which she obtained from Mr. Kresge at the time of her acquisition. His adjusted basis for the shares she sold in 1938 would have been $0.159091.

When the petitioner and Mr. Kresge were married he was 57 years old with a life expectancy of 16½ years. She was then 32 years of age with a life expectancy of 33¾ years. He was then worth approximately $375,000,000 and owned real estate of the approximate value of $100,000,000.

The Commissioner determined the deficiency on the ground that the petitioner's stock obtained as above stated was acquired by gift within the meaning of that word as used in [1954 Code, §1015(a)], and, as the transfer to her was after December 31, 1920, used as the basis for determining the gain on her sale of it the basis it would have had in the hands of the donor. This was correct if the just mentioned statute is applicable, and the Tax Court held it was on the authority of Wemyss v. Commissioner, [infra page 1025], and Merrill v. Fahs, [infra page 1027].

The issue here presented cannot, however, be adequately dealt with quite so summarily. The *Wemyss* case determined the taxability to the transferor as a gift, under [1954 Code, §§2511(a) and 2512(b)] of property transferred in trust for the benefit of the prospective wife of the transferor pursuant to the terms of an ante-nuptial agreement. It was held that the transfer, being solely in consideration of her promise of marriage, and to compensate her for loss of trust income which would cease upon her marriage, was not for an adequate and full consideration in money or money's worth within the meaning of [1954 Code, §2512(b)], the Tax Court having found that the transfer was not one at arm's length made in the ordinary course of business. But we find nothing in this decision to show that a transfer, taxable as a gift under the gift tax, is ipso facto to be treated as a gift in construing the income tax law.

In Merrill v. Fahs, supra, it was pointed out that the estate and gift tax statutes are in pari materia and are to be so construed. . . . The estate tax provisions in the Revenue Act of 1916 required the inclusion in a decedent's gross estate of transfers made in contemplation of death, or intended to take effect in possession and enjoyment at or after death except when a transfer was the result of a "bona fide sale for a fair consideration in money or money's worth." Sec. 202(b), 39 Stat. 756, 777. The first gift tax became effective in 1924, and provided inter alia, that where an exchange or sale of property was for less than a fair consideration in money or money's worth the excess should be taxed as a gift. Rev. Act of 1924,

§320, 43 Stat. 314. While both taxing statutes thus provided, it was held that a release of dower rights was a fair consideration in money or money's worth. . . . Following that, Congress in 1926 replaced the words "fair consideration" in the 1924 Act limiting the deductibility of claims against an estate with the words "adequate and full consideration in money or money's worth" and in 1932 the gift tax statute as enacted limited consideration in the same way. Rev. Act 1932, §503. Although Congress in 1932 also expressly provided that the release of marital rights should not be treated as a consideration in money or money's worth in administering the estate tax law, Rev. Act of 1932, §804, and failed to include such a provision in the gift tax statute, it was held that the gift tax law should be construed to the same effect. Merrill v. Fahs, supra.

We find in this decision no indication, however, that the term "gift" as used in the income tax statute should be construed to include a transfer which, if made when the gift tax were effective, would be taxable to the transferor as a gift merely because of the special provisions in the gift tax statute defining and restricting consideration for gift tax purposes. A fortiori, it would seem that limitations found in the estate tax law upon according the usual legal effect to proof that a transfer was made for a fair consideration should not be imported into the income tax law except by action of Congress.*

In our opinion the income tax provisions are not to be construed as though they were in pari materia with either the estate tax law or the gift tax statutes. They are aimed at the gathering of revenue by taking for public use given percentages of what the statute fixes as net taxable income. Capital gains and losses are, to the required or permitted extent, factors in determining net taxable income. What is known as the basis for computing gain or loss on transfers of property is established by statute in those instances when the resulting gain or loss is recognized for income tax purposes and the basis for succeeding sales or exchanges will, theoretically at least, level off tax-wise any hills and valleys in the consideration passing either way on previous sales or exchanges. When Congress provided that gifts should not be treated as taxable income to the donee there was, without any correlative provisions fixing the basis of the gift to the donee, a loophole which enabled the donee to make a subsequent transfer of the property and take as the basis for computing gain or loss its value when the gift was made. Thus it was possible to exclude from taxation any increment in value during the donor's holding and the donee might take advantage of any shrinkage in such increment after the acquisition by gift in computing gain or loss upon a subsequent sale or exchange. It was to close this loophole that Congress provided that the donee should take the donor's basis when property was transferred by gift.† This change in the statute affected only the statutory net taxable income. The altered statute prevented a transfer by gift from creating any change in the basis of the property in computing gain or loss on any future transfer. In any individual instance the change in the statute would but postpone taxation and presumably would have little effect on the total volume of income tax revenue derived over a long period of time and from many taxpayers. Because of this we think that a transfer which would be classed as a gift under the gift tax law is not necessarily to be treated as a gift income-tax-wise. Though such a consideration as this petitioner gave for the shares of stock she acquired from Mr. Kresge might not have relieved him from liability for a gift tax, had the present gift tax then been in ef-

* See the suggestion of Judge Jerome N. Frank that the terms "gift," "gaft," and "geft" be used, depending upon whether the gift, income, or estate tax meaning is implied. Commissioner v. Beck's Estate, infra page 998. — Ed.

† The history of this change is given supra page 101n. — Ed.

fect, it was nevertheless a fair consideration which prevented her taking the shares as a gift under the income tax law since it precluded the existence of a donative intent.

Although the transfers of the stock made both in December 1923, and in the following January by Mr. Kresge to this taxpayer are called a gift in the ante-nuptial agreement later executed and were to be for the protection of his prospective bride if he died before the marriage was consummated, the "gift" was contingent upon his death before such marriage, an event that did not occur. Consequently, it would appear that no absolute gift was made before the ante-nuptial contract was executed and that she took title to the stock under its terms, viz.: in consideration for her promise to marry him coupled with her promise to relinquish all rights in and to his property which she would otherwise acquire by the marriage. Her inchoate interest in the property of her affianced husband greatly exceeded the value of the stock transferred to her. It was a fair consideration under ordinary legal concepts of that term for the transfers of the stock by him. . . . She performed the contract under the terms of which the stock was transferred to her and held the shares not as a donee but as a purchaser for a fair consideration.

As the decisive issue is one of law only, the decision of the Tax Court interpreting the applicable statutory provisions has no peculiar finality and is reviewable. Bingham v. Commissioner, 325 U.S. 365.

Decision reversed.

CLARK, Circuit Judge (dissenting).

The opinion accepts two assumptions, both necessary to the result. The first is that definitions of gift under the gift and estate tax statutes are not useful, in fact are directly opposed to, definitions of gift under the capital-gains provision of the income tax statute. The second is that the circumstances here of a transfer of the stock some months before the marriage showed, contrary to the conclusions of the Tax Court, a purchase of dower rights, rather than a gift. The first I regard as doubtful; the second, as untenable.

It is true that Commissioner v. Wemyss and Merrill v. Fahs, supra, which would require the transactions here to be considered a gift, dealt with estate and gift taxes. But no strong reason has been advanced why what is a gift under certain sections of the Revenue Code should not be a gift under yet another section As a matter of fact these two cases indicate that the donative intent of the common law is not an essential ingredient of a gift for tax purposes. Conversely love, affection, and the promise of future marriage will not be consideration adequate to avoid the gift tax. If that is so, it would seem that these should not be sufficient to furnish new and higher cost bases for computing capital gains on ultimate sale. The Congressional purpose would seem substantially identical — to prevent a gap in the law whereby taxes on gifts or on capital gains could be avoided or reduced by judicious transfers within the family or intimate group.

But decision on that point might well be postponed, since, to my mind, the other point should be decisive. Kresge transferred the stock to petitioner more than three months before their marriage. Part was given when Kresge was married to another woman. At these times petitioner had no dower or other rights in his property. If Kresge died before the wedding, she could never secure dower rights in his lands. Yet she would nevertheless keep the stock. Indeed the specifically stated purpose of the transfer was to protect her against his death prior to marriage. It is therefore difficult to perceive how her not yet acquired rights could be consideration for the stock. Apparently the parties themselves shared this difficulty, for in their subsequent instrument releasing dower rights they referred to the stock transfer as a gift and an ante-nuptial settlement.

If the transfer be thus considered a sale, as the majority hold, it would seem to follow necessarily that this valuable consideration (equivalent to one-third for life in land valued at one hundred million dollars) should have yielded sizable taxable capital gains to Kresge, as well as a capital loss to petitioner when eventually she sold. I suggest these considerations as pointing to the unreality of holding as a sale what seems clearly only intended as a stimulating cause to eventual matrimony.

Since Judge Murdock in the Tax Court found this to be a gift, not a sale, and since this decision is based in part at least upon factual considerations, it would seem binding upon us. At any rate, it should be persuasive of the result we ought to reach.

NOTE

The scope of Farid-es-Sultaneh. Having concluded that the 1924 transaction was not a "gift" under §1015(a), why did the court determine that the taxpayer's basis for the stock was its fair market value in 1924? See §1012. Did the taxpayer realize income in 1924? Did Mr. Kresge engage in a "sale or other disposition" of the stock in 1924, within the meaning of §1001, so as to reckon up his gain or loss then? If so, what was the amount of his gain or loss? See United States v. Davis, infra page 432.

Does a wife realize taxable income when her husband supports her?

2. *Prizes, Scholarships, and Fellowships*

Section 74 (prizes and awards) and §117 (scholarships and fellowship grants) were new in the 1954 Code. Previously, the status of such receipts depended upon whether they came within the more general language of what is now §102(a), excluding "gifts" from gross income.

SIMMONS v. UNITED STATES
308 F.2d 160 (4th Cir. 1962)

Before SOBELOFF, Chief Judge, and HAYNSWORTH and BOREMAN, Circuit Judges.

SOBELOFF, Chief Judge.

Diamond Jim III, a rock fish, was one of millions of his species swimming in the Chesapeake Bay, but he was a very special fish, and he occasions some nice legal questions. Wearing a valuable identification tag, he was placed on June 19, 1958, in the waters of the Bay by employees of the American Brewery, Inc., with the cooperation of Maryland state game officials. According to the well-publicized rules governing the brewery-sponsored Third Annual American Beer Fishing Derby, anybody who caught Diamond Jim III and presented him to the company, together with the identification tag and an affidavit that he had been caught on hook and line, would be entitled to a cash prize of $25,000.00. The company also placed other tagged fish in the Chesapeake, carrying lesser prizes.

Fishing on the morning of August 6, 1958, William Simmons caught Diamond Jim III. At first, he took little notice of the tag, but upon re-examining it a half hour later, he realized that he had caught the $25,000.00 prize fish. After Simmons and his fishing companions appropriately marked the happy event, he hastened to comply with the conditions of the contest. Soon thereafter, in the course of a television appearance arranged by the brewery, he received the cash prize. The record shows that Simmons knew about the contest, but, as an experienced fisherman, he also knew that his chances of landing that fish were minuscule, and he did not have Diamond Jim III in mind when he set out that morning.

Thereupon, an alert District Director of the Internal Revenue Service came forward with the assertion that the cash prize was includable in Simmons' gross income under section 61(a) and section 74(a) of the Internal Revenue Code, and assessed a tax deficiency of $5,230.00. Promptly Simmons paid and filed a claim for refund. . . .

I

We turn first to the taxpayer's contention that the prize money is excluded from his gross income by the terms of section 74(b). . . . We do not understand the taxpayer to claim immunity from the tax on the ground that capture of the fish or the award of the prize had any religious, charitable, scientific, educational, artistic, or literary significance whatever. His argument is that the payment was made in recognition of a civic achievement. He attributes a civic purpose to the American Brewery, Inc., in offering a prize the effect of which, he says, is to popularize the recreation and resort facilities of the state of Maryland. Yet it requires a considerable flight of fancy to romanticize the Fishing Derby into a civic endeavor. A glance at the advertisements announcing first the Derby and later the capture of Diamond Jim III unmistakably reveals that the purpose of the contest and of the prize was to stimulate the sale of American beer.

But even if a civic purpose could be discerned in the company's campaign, we are of the opinion that it is not the motivations of the donor that are legally relevant. The statute and its legislative history speak only of the character of the recipient's achievement, and the crucial test is the nature of the activity being rewarded. For example, if Simmons' achievement cannot be considered one of those enumerated in section 74(b), the exclusion provided in that section would not apply even if the prize were given by the state of Maryland to further a promotional campaign for its facilities. Conversely, if the recipient's achievement were "civic" in the sense of the statute, he would be entitled to its benefits even though the donor had a commercial purpose in making the award.

The taxpayer advances the further argument that a jury could reasonably find that the payment was for a civic achievement since it rewarded his skill as a fisherman, and that it was therefore error to refuse to permit the jury to determine the issue. To agree that these facts present a jury question would distort both the basic concept of the statutory exclusion and the meaning of the language used.

While dictionary definitions are not an infallible guide to the exact meaning of statutory language, they may limit the range of possible meanings. The word "civic" is defined as "[r]elating, pertaining, or appropriate, to a citizen." One may be said to be a civic person if he merely lives in a state and quietly obeys its laws, but a "civic achievement" involves more. It implies positive action, exemplary, unselfish, and broadly advantageous to the community. This interpretation of the phrase is reinforced by a consideration of the other types of achievement singled out in section 74(b). While the class of civic achievements is not limited to the others specifically enumerated, it must resemble them in general character, and they all represent activities enhancing in one way or another the public good. Although the qualifying word "civic" is the last in the enumeration of achievements, it should not be treated as a limitless extension of the previously enumerated classes, for that would erase all distinctions and make the exclusion almost as broad as the taxing provision of subsection (a). Moreover, the statute's legislative history indicates that only awards for genuinely meritorious achievements were to be freed from taxation. Thus, Nobel and Pulitzer prizes were there cited as examples of awards to be within the exclusionary provisions of sec-

tion 74(b), while prizes given in "radio and television giveaway shows, or as door prizes, or in any similar type contest" were to be taxed as income.

Viewing the facts most favorably to the taxpayer, we hold that he was not rewarded for a civic achievement, properly interpreted. There was nothing meritorious in a civic sense in catching this rock fish. Simmons was not even rewarded for an extraordinary display of skill, if that could be considered a civic achievement, for catching Diamond Jim III was essentially a matter of luck. The case might be different if, for example, Simmons had at considerable risk to himself captured and destroyed a killer whale terrorizing the Maryland seashore. That could have been regarded as a genuine civic achievement. But catching this fish cannot reasonably be so denominated, for the only community interest in the event was one of idle curiosity. Innumerable are the rhapsodies uttered in praise of the delights and virtues of the piscatorial pastime, but never to our knowledge has it been seriously called a civic enterprise. The character of this fortuitous event is not raised to a civic level by being linked to an advertising campaign aimed at selling beer. Far from resembling a Nobel or Pulitzer prize-winner, Mr. Simmons fits naturally in the less-favored classification the legislators reserved for beneficiaries of "giveaway" programs.

II

The taxpayer's next point is that he was at least entitled to have a jury decide whether the $25,000.00 payment to him was a gift, excluded from gross income by section 102. The Supreme Court's exposition of this branch of the law in Commissioner of Internal Revenue v. Duberstein, 363 U.S. 278 (1960), is of course controlling, and this court expressed its understanding of that decision in Poyner v. Commissioner, 301 F.2d 287 (4th Cir. 1962). Here it suffices to repeat that it is the function of the trier of fact to determine the basic facts and from these to infer the motivations of the donor. This does not mean, however, that in an appropriate case a district judge may not make a decision on summary judgment. Where, from the facts stipulated and submitted on affidavit, when viewed in the light most favorable to the taxpayer, it plainly appears that a jury could not reasonably infer that the payments were motivated "out of affection, respect, admiration, charity or like impulses," or from a "detached or disinterested generosity," or from similar sentiments, summary judgment for the Government is the correct disposition. Such is the present case.

The established fact is that there was no personal relationship between Simmons and the brewery to prompt it to render him financial assistance. Nor was it impelled by charitable impulses toward the community at large, for the prize was to be paid to whoever caught Diamond Jim III, regardless of need or affluence. Rather, the taxpayer has apparently rendered the company a valuable service, for, by catching the fish and receiving the award amid fanfare, he brought to the company the publicity the Fishing Derby was designed to generate.

Moreover, under accepted principles of contract law on which we may rely in the absence of pertinent Maryland cases, the company was legally obligated to award the prize once Simmons had caught the fish and complied with the remaining conditions precedent. The offer of a prize or reward for doing a specified act, like catching a criminal, is an offer for a unilateral contract. For the offer to be accepted and the contract to become binding, the desired act must be performed with knowledge of the offer. The evidence is clear that Simmons knew about the Fishing Derby the morning he caught Diamond Jim III. It is not fatal to his claim for refund that he did not go fishing for the express purpose of catching one

of the prize fish. So long as the outstanding offer was known to him, a person may accept an offer for a unilateral contract by rendering performance, even if he does so primarily for reasons unrelated to the offer. Consequently, since Simmons could require the company to pay him the prize, the case is governed by Robertson v. United States, 343 U.S. 711, 713-714 (1952). There, the Supreme Court held [under the 1939 Code] that, since the sponsor of a contest for the best symphonies submitted was legally obligated to award prizes in accordance with his offer, the payment made was not a gift to the recipient.

III

Having shown that the payment does not fall within any statutory exclusion, it remains to consider whether it is income within sections 61(a) and 74(a) and whether the Constitution confers upon Congress the power to tax this money. It is necessary first to examine the source of the Congressional taxing power, its scope and its limitations, to demonstrate that the appellant's position is untenable.

[The court decided that the tax was an indirect tax that could be levied by Congress by virtue of Article I, Section 8, Clause 1 of the Constitution, without apportionment among the states; but went on to hold that in any event the Sixteenth Amendment made apportionment unnecessary.]

2. Even if we were to assume that the tax upon Simmons is direct, it comes within the Sixteenth Amendment, which relieved direct taxes upon income from the apportionment requirement. We need look no further than the two most recent Supreme Court cases in this area. In Commissioner of Internal Revenue v. Glenshaw Glass Co., 348 U.S. 426 (1955), the Court upheld the inclusion in gross income of money received by the taxpayers as punitive damages, stating that "[h]ere we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." This test was specifically reaffirmed in James v. United States, 366 U.S. 213 (1961), where the Court considered the taxability of embezzled money. The plunder was held to be income solely because it came into the taxpayer's possession and control and despite the fact that he had no right to it and indeed was under a legal obligation to return it to its rightful owner. This obligation to repay was deemed irrelevant, for a gain "constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it." As is apparent from the quoted statements, and as illustrated by the diverse factual situations in these cases, it is the status in the recipient's hands of the money being taxed which is the crucial factor, while the source of the money is not relevant.

The $25,000.00 received by Simmons squarely meets these tests laid down by the Supreme Court. The receipt of this sum constitutes an economic gain over which he has complete control and, better than the situation in *James,* complete legal right. Whether the money came to Simmons as a gift, or as a return for services, or for some other reason, it still is income to him.

It might be contended that reliance cannot properly be placed upon the *Glenshaw* and *James* decisions because they purport to interpret the meaning of "income" only as used in section 61 of the Internal Revenue Code and not as used in the Sixteenth Amendment. However, the opinions in both cases show that the Supreme Court was aware of the constitutional issues. In *Glenshaw,* these were dismissed in a single sentence. In *James,* the constitutional issues were unmistakably brought to the Court's notice by the dissent of Mr. Justice Whittaker. His sole objection was that the taxpayer had no legal rights to the money, and therefore, in his opinion, there was no economic gain that could be constitutionally

taxed. This feature of the controversy in *James* is not present in our case because Simmons enjoys a permanent economic benefit, not subject to any claim of restitution. None of the several opinions of the Justices in *James* intimates a doubt of the constitutional validity of a tax upon a true gain.

Moreover, the constitutional and the statutory provisions are closely related. The language of section 61, a paraphrase of the Sixteenth Amendment, "was used by Congress to exert in this field the full measure of its taxing power." [Commissioner v. Glenshaw Glass Co., 348 U.S. at 429.] This means that Congress intended to avail itself to the utmost of the exemption granted it by the Sixteenth Amendment from the requirement of article I, section 8, clause 1, that direct taxes shall be apportioned. Thus, the Court, in upholding taxes on income imposed by section 61 which might also be direct taxes, necessarily decides that such taxes are authorized by the Sixteenth Amendment. And conversely, from our conclusion here that Simmons received income within the meaning of that amendment, it necessarily follows that it is taxed by sections 61(a) and 74(a).

Affirmed.

NOTE

1. *Prizes as excludable "gifts"?* Does the court's discussion of the taxpayer's second point (that the amount received by him was a "gift") imply that *some* prizes and awards can be excluded from income as gifts? What is the relation between the general rule of §74(a) and the exclusion of gifts found in §102(a)? diff between prizes + awards + gift

How should the following amounts be treated:

(a) An award received in a beauty or popularity contest by a girl whose name is entered by an admiring friend without her knowledge? 74(a) - includable

(b) An award to the mother of the first set of twins born after New Year's Eve? Would it matter whether the donor was a diaper laundry service or the Planned Parenthood League? 74(a)

(c) An award by an octogenarian to whichever of his children has the largest family? 102(a)

(d) An award by the New York Times to one of the "Hundred Neediest Cases"? 102(a)

(e) The Stalin (or Lenin) Peace Prize? Paul Robeson's award, received in 1953, was treated by the Internal Revenue Service as an exempt "gift" under the 1939 Code. IR-277 (Feb. 4, 1959).

2. *Valuing the prize or award.* How much must be reported if a taxable prize consists of a trip to Miami, a lifetime supply of fig newtons, or something else that the winner would not have purchased with his own money? See Turner v. Commissioner, ¶54,142 P-H Memo T.C. (cruise tickets; value to the winner, not retail value, controls); Rev. Rul. 57-374, 1957-2 C.B. 69 (winner declined to accept all-expense paid vacation trip; held, no income); see also Rev. Rul. 62-74, 1962-1 C.B. 68 (winner taxed on present discounted value of cash award that was placed in escrow account by contest sponsor to be paid over several years).

REV. RUL. 59-118

1959-1 C.B. 41 (1959)

Advice has been requested whether amounts received from the Veterans Administration by an individual, who is enrolled at a university as a candidate for a doctoral degree in psychology and who is required to serve a training period at Veterans Administration hospitals as a staff assistant, are excludable from gross income under section 117 of the Internal Revenue Code of 1954.

The Veterans Administration conducts a unified psychology training program in cooperation with universities approved for doctoral training in psychology by the American Psychological Association. The dual purpose of the program is to furnish a continuing source of qualified staff psychologists for the Administra-

tion's Department of Medicine and Surgery and to provide needed services for which psychological technicians would otherwise have to be employed. Throughout the training period, trainees pursue their academic studies at the university and give part-time service toward meeting hospital and clinic needs, under the joint jurisdiction and supervision of university and Veterans Administration staffs. While preparing for full-time staff positions, the trainees serve as a part of the work force of the hospitals and render service to patients. The trainees, functioning as junior staff members, constitute an essential part of psychology services at the stations to which they are assigned.

All candidates for such traineeship are initially selected by the department of psychology of an approved university, and such individual must have at least a bachelor's degree from a college or university of recognized standing. The candidate must submit to the university and to the Veterans Administration Standard Form 57, Application for Federal Employment. Individuals who already have an advanced degree in psychology, but lack necessary experience, may apply for training if they are sponsored by one of the participating universities. During the training period the trainees are paid for the number of hours actually worked at Veterans Administration stations to which assigned at such compensation rates as are established with reference to the base full-time applicable pay levels of the Federal civil service. They are employees of the United States Government.

Section 1.117-4(c) of the Income Tax Regulations provides, in part, that if any amount paid or allowed to, or on behalf of, an individual to enable him to pursue studies or research, represents compensation for past, present, or future employment services, or represents either payment for services which are subject to the direction or supervision of the grantor, or research primarily for the benefit of the grantor, such payments or allowances shall not be considered as amounts received as a scholarship or a fellowship grant for the purpose of section 117 of the Code.

The fact that such individuals are also attending graduate school at a university does not change their status as employees of the Veterans Administration. Revenue Ruling 57-386, C.B. 1957-2, 107, holds that stipends received by interns and residents at a training hospital who assisted in the care of patients as a part of their training represented compensation for services and not nontaxable fellowship grants. They were primarily performing services for the hospital even though in the process they were acquiring training and experience in their particular specialties. See also Revenue Ruling 56-101, C.B. 1956-1, 89, and Revenue Ruling 57-385, C.B. 1957-2, 109.

Revenue Ruling 57-560, C.B. 1957-2, 108, holds that amounts received from the Mayo Foundation and Mayo Properties Association as fellowship grants and cost-of-living allowances by doctors of medicine, who are studying for graduate degrees at a clinic or hospital, are excludable from gross income under section 117 of the Code, where the doctors rendered no services to the hospital or clinic, replaced no personnel who would be employed on a salary basis, and performed no functions for the benefit of the grantor or training institution. None of these conditions exist in the instant case.

Accordingly, it is held that the amounts paid by the Veterans Administration to graduate students while serving a training period at Veterans Administration hospitals as staff assistants, as a condition to receiving a doctorate degree in psychology from a university, represent compensation for services rendered and not nontaxable scholarship or fellowship grants. Such amounts are includible in the student-employees' gross income under section 61 of the Code.

Revenue Ruling 57-560, C.B. 1957-2, 108, distinguished.

NOTE

1. *Scholarships and fellowship grants.* Section 117 distinguishes between persons who are candidates for degrees and those who are not. The exclusion is allowed to non-candidates by §117(b)(2) only if the grantor is a tax-exempt institution, government, or similar agency of the types specified by §117(b)(2)(A), and the exclusion is limited to $300 per month for a total period of 36 months. Candidates for degrees are not subject to these restrictions. As to employment, a candidate for a degree is taxable to the extent that his scholarship or fellowship grant "represents payment for teaching, research, or other services in the nature of part-time employment," unless the services are required of all candidates for the degree; in the case of non-candidates, however, there is no explicit statutory prohibition on employment. But Regs. §1.117-4(c) provides that even if an amount is paid to enable the recipient to pursue studies or research, it does not qualify as a scholarship or fellowship grant if it "represents either compensation for past, present, or future employment services or represents payment for services which are subject to the direction or supervision of the grantor" — unless §117(b)(1) (services required of all candidates for a degree) is applicable.

If all candidates for the doctorate in psychology at a particular university were required to serve a training period at a veterans' hospital, would the compensatory character of their stipends be excused by the reference in §117(b)(1) to "services required of all candidates (whether or not recipients of scholarships or fellowship grants) for a particular degree"? Or is the ruling based on the theory that the amounts in question were not "scholarships or fellowship grants"? Does anything turn on the fact that the stipends were paid by the agency that operated the hospitals, rather than by an independent grantor? See Regs. §1.117-4(c)(2), disqualifying amounts received for the pursuit of studies or research pursued "primarily for the benefit of the grantor." If an intern or resident at a hospital receives a grant from the Ford Foundation as support while he completes his medical training, would the fact that his training consists entirely of looking after patients disqualify him for the exclusion? Would a non-teaching member of a university faculty qualify for the exclusion of §117(b)(2), if the university labels his regular stipend as a "fellowship" rather than "salary"? Could a university employ its professors to teach for half their regular salaries and pay the rest to them as "research fellowships"?

For other problems in applying §117, consult any post-doctoral fellow in your university's department of physics or chemistry; see also Bachmura v. Commissioner, 32 T.C. 1117 (1959); Rev. Rul. 61-65, 1961-1 C.B. 17 (Fulbright grants); Ussery v. United States, 296 F.2d 582 (5th Cir. 1961); Woddail v. Commissioner, 321 F.2d 721 (10th Cir. 1963) (physician serving in hospital and receiving training; stipend held taxable).

2. *Relation of §102(a) to §117.* Does the introductory clause of §74(a) imply that a scholarship or fellowship grant that does not meet the standards of §117 is ipso facto includible in gross income? Or is there an alternate route to immunity: the exemption accorded to gifts by §102(a)? In this connection, consider whether a payment received to enable a professor to pursue his research can qualify as a gift under §102(a) even though it fails to qualify for an exclusion under §117 because, e.g., it exceeds the $300-36 month restriction or is paid by a non-qualified grantor. According to Regs. §1.117-3(a) and (c), an amount paid by an individual to aid a relative or friend in pursuing his studies or research does not constitute a "scholarship" or "fellowship grant" if the grantor "is motivated by family or philanthropic considerations."

3. *Expenses defrayed by a grant.* As to the exclusion under §117(a)(2) of amounts "received to cover expenses," Regs. §1.117-1(b)(2)(i) requires that the amount be "specifically designated" for this purpose if the grant was awarded after July 28, 1956 (when this requirement was originally promulgated). For the possibility of deducting such amounts (even if not properly designated) as business expenses, see page 260 infra.

4. *Awards to children of grantor's employees.* If a business corporation establishes a scholarship program for the children of its employees, is it possible that the awards will be excluded from the children's income by §117 but included in the parents' income by §61(a)? What if the employee has a bright child and goes to work for an employer with such a program in the hope that his child will qualify for an award? [illegible] qualify him

5. *Effect of scholarship on dependency claim.* In determining whether a taxpayer has provided more than half of the "support" of a child for whom he claims a dependency exemption under §151(e), an amount received by the child as a "scholarship for study at an educational institution" is disregarded by virtue of §152(d). In Ide v. Commissioner, 40 T.C. 721 (1963), the court apparently accepted the government's theory that the term "scholarship" as used in §152(d) should be given the same meaning as in §117.

6. *References.* Gordon, Scholarship and Fellowship Grants as Income: A Search for Treasury Policy, 1960 Wash. U.L.Q. 144; Mansfield, Income from Prizes and Awards and from Scholarship and Fellowship Grants, 19 N.Y.U. Inst. on Fed. Taxation 129 (1961); Note, Federal Tax Incentives for Higher Education, 76 Harv. L. Rev. 369 (1962).

3. *Bequests*

In addition to excluding gifts from gross income, §102 of the 1954 Code provides for the exclusion of property acquired by bequest, inheritance, or devise. In doing so, it carries forward §22(b)(3) of the 1939 Code without substantive change. Section 1014 provides that the basis to the heir of such property is its fair market value at the date of the decedent's death, unless the decedent's executor elected under §2032 to value the estate as of one year after death, in which event the optional valuation is controlling. This use of the date-of-death value (or, when applicable, the optional date value) was carried forward by §1014 without change from §113(a)(5) of the 1939 Code, but it was extended in 1954 to embrace property that was not acquired by bequest, inheritance, or devise but was nevertheless includible in the decedent's estate for federal estate tax purposes.

NOTE

1. *Acquisition by "bequest, etc."* The exclusion of property received by bequest, devise, or inheritance has produced an occasional conflict between "bequests" and "compensation" analogous to the *Duberstein* problem, supra page 119, of gift vs. compensation. In McDonald v. Commissioner, 2 T.C. 840 (1943), §102(a) was held to apply to property left to the taxpayer by her employer, for whom she had acted as nurse, secretary, dietitian, and driver, "in appreciation of the many years of loyal service and faithful care rendered me." But compare Davies v. Commissioner, 23 T.C. 524 (1954) (amount received in compromise of claim against an estate based upon an oral contract whereby the decedent promised to take care of the taxpayer in his will in exchange for taxpayer's services; held not excludable); Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959) (same).

When a testator names a relative or friend as executor, it is common to provide for a "bequest" in lieu of the statutory commissions to which the executor would be entitled for his services. The Supreme Court has held that if mere qualification as executor (as distinguished from the performance of services) is sufficient to entitle the individual to the payment, it constitutes a bequest rather than taxable compensation. United States v. Merriam, 263 U.S. 179 (1923). See Bank of New York v. Helvering, 132 F.2d 773 (2d Cir. 1943), illustrating the difficulty courts have encountered in applying the Supreme Court's distinction. Query: why should the testator have required the individual to qualify as executor to be eligible for the bequest? Would one really be entitled to the bequest if he qualified and promptly resigned without cause? In the *Bank of New York* case, the amount granted to the executor by the will exceeded the statutory commissions, and the executor (or rather his executors, since in the meantime he had died) treated only the excess as a bequest. Was this too generous to the government?

In Valleskey v. Nelson, 271 F.2d 6 (7th Cir. 1959), the taxpayer sold property that he had purchased from a decedent's estate for less than its fair market value by virtue of an option granted to him by the decedent's will. The court held that the property was acquired by purchase, not by bequest, so that the taxpayer's basis was his cost, not the

property's fair market value at the date of the decedent's death. The court did not explain why the taxpayer could not add the fair market value of the *option* to his cash outlay, on the theory that he acquired the option by bequest; but see Helvering v. San Joaquin Fruit & Investment Co., infra page 450.

2. *Property acquired in settlement of will contest.* In Lyeth v. Hoey, 305 U.S. 188, 195-197 (1938), the Supreme Court held that the grandson of a decedent who had received an amount in settlement of a will contest could exclude it under §102(a):

> Petitioner was concededly an heir of his grandmother under the Massachusetts statute. It was by virtue of that heirship that he opposed probate of her alleged will which constituted an obstacle to the enforcement of his right. Save as heir he had no standing. Seeking to remove that obstacle, he asserted that the will was invalid because of want of testamentary capacity and undue influence. . . . It was in that situation, facing a trial of the issue of the validity of the will, that the compromise was made by which the heirs, including the petitioner, were to receive certain portions of the decedent's estate. . . .
>
> Respondent agrees that the word "inheritance" as used in the federal statute is not solely applicable to cases of complete intestacy. The portion of the decedent's property which petitioner obtained under the compromise did not come to him through the testator's will. That portion he obtained because of his heirship and to that extent he took in spite of the will and as in case of intestacy. The fact that petitioner received less than the amount of his claim did not alter its nature or the quality of its recognition through the distribution which he did receive.

If the taxpayer's status as an heir of the decedent had been in dispute, would a payment in compromise of his claim have been tax-free? In United States v. Gavin, 159 F.2d 613 (9th Cir. 1947), a payment to one claiming as an illegitimate child of the deceased was held tax-free, though as part of the compromise the claimant agreed to refrain from asserting her paternity in the future and consented to a probate decree finding against the relationship.

See also Hopkins v. Commissioner, 13 T.C. 952 (1949) (Lyeth v. Hoey held inapplicable where property used to settle will dispute came from decedent's widow rather than from his estate).

See generally, Schenck, Tax Effects of Will Contests and Compromises, 1961 Tulane Tax Inst. 214.

3. *Income in respect of a decedent.* If a bequest consists of an uncollected claim for salary, commissions, or fees, which was not reported as income by the decedent during his lifetime because he was on the cash basis, the heir is not taxed when he inherits the claim; but he will be taxed on collecting it under §691, relating to "income in respect of a decedent." For more on this troublesome subject, see infra page 1075.

4. *Gift or bequest of income from property.* If A receives property by gift or inheritance, the value of the property itself is tax-exempt under §102(a), but he must report the income of the property thereafter. But if Blackacre is transferred (either inter vivos or on death) to A for life, remainder to B, what is the status of the income during A's life? Note that if both Blackacre itself and the income it produces during A's life were exempt from tax, the exemption for gifts and bequests would be larger when split interests were created than if the property had been given outright. In Irwin v. Gavit, 268 U.S. 161 (1925), the Supreme Court rejected the contention that the income beneficiary of a trust was immune from tax:

> The language quoted [now §102(a)] leaves no doubt in our minds that if a fund were given to trustees for A for life with remainder over, the income received by the trustees and paid over to A would be income of A under the statute. It seems to us hardly less clear that even if there were a specific provision that A should have no interest in the corpus, the payments would be income none the less, within the meaning of the statute and the Constitution and by popular speech. In the first case it is true that the bequest might be said to be of the corpus for life, in the second it might be said to be of the income. But we think that the provision of the act that exempts bequests [i.e., §102(a)] assumes the gift of a corpus and contrasts it with the income arising from

it, but was not intended to exempt income properly so-called simply because of a severance between it and the principal fund. No such conclusion can be drawn from Eisner v. Macomber, 252 U.S. 189, 206, 207. The money was income in the hands of the trustees and we know of nothing in the law that prevented its being paid and received as income by the donee.

The Courts below went on the ground that the gift to the plaintiff was a bequest and carried no interest in the corpus of the fund. We do not regard those considerations as conclusive, as we have said, but if it were material a gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund. Apart from technicalities we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it. The fund is appropriated to the production of the same result whichever form the gift takes. Neither are we troubled by the question where to draw the line. That is the question in pretty much everything worth arguing in the law. . . . Day and night, youth and age are only types. But the distinction between the cases put of a gift from the corpus of the estate payable in instalments and the present seems to us not hard to draw, assuming that the gift supposed would not be income. [268 U.S. at 166-167.]

Section 102(b)(2) was enacted in 1942 to codify the rule of Irwin v. Gavit.

Note that this scheme assigns the entire benefit of the gift exclusion to the remainderman. Congress might, in the alternative, have divided the exclusion between life tenant and remainderman. For example, if the property transferred is worth $100,000 and A is 30 years old, his life estate is worth about $72,000 and B's remainder about $28,000 (Table I, Regs. §20.2031-7). These interests could be exempted from tax, with the excess over them taxed as income, by (a) allowing A to deduct an appropriate portion of his $72,000 each year from the income actually received and (b) requiring B to report the difference between $28,000 and the value of the transferred property as income, either when his remainder fell in or in aliquot portions in the preceding years. Under this alternative approach, the net amount taxed would be the same as under the first sentence of §102(b), but it would be divided between A and B instead of being attributed solely to A. Note that §102(b)'s treatment of A is made more explicit by §273, denying him the right to amortize the value of his life estate.

The second sentence of §102(b), also enacted in 1942, is concerned with a transfer of property, under which A is to receive an annuity (or other periodic payments) payable out of either income or corpus. Burnet v. Whitehouse, 283 U.S. 148 (1931), held that such amounts were excluded from income by §102(a), whether paid from income or not, so long as they could be paid out of corpus if necessary. By virtue of the 1942 change in the statute, these amounts are now taxable to the extent paid or credited from income. If the transfer is in trust, this provision of §102(b) must be considered in conjunction with §663(a)(1) and certain other sections of Subchapter J. The *Whitehouse* case is still applicable to lump sum payments, as distinguished from amounts to be paid "at intervals." Lindau v. Commissioner, 21 T.C. 911 (1954).

5. *Basis of inherited property*. For many years, the heir's basis for property acquired by bequest, inheritance, or devise has been its fair market value on the date of the decedent's death (or on the optional valuation date if the excutor elected under §2032 to use this date in valuing the estate for federal estate tax purposes). Because so much property has increased in value over the years, the date-of-death value is often referred to as a "stepped-up" basis, though a "stepped-down" basis is the result if the property declined in value during the decedent's ownership.

Before 1954, property that had been transferred by the decedent during his lifetime (e.g., property transferred in contemplation of death) was not ordinarily entitled to a date-of-death basis, even though it was included in his estate in computing the federal estate tax. The 1954 Code remedied this disparity in large part by adding paragraphs (2) through (9) of §1014(b). For more on §1014, see infra page 1074.

The value of inherited property on the date of death (or on the optional valuation date) is controlling even though distribution is postponed. See Regs. §1.1014-4(a)(2), providing that "all titles to property acquired by bequest, devise, or inheritance relate back to the death of the decedent, even though the interest of the person taking the title was, at the

date of death of the decedent, legal, equitable, vested, contingent, general, specific, residual, conditional, executory, or otherwise." This regulation was upheld in Helvering v. Reynolds, 313 U.S. 428 (1941), requiring the contingent remainderman under a testamentary trust created on his father's death in 1918 to use as his basis the 1918 value of property distributed to him in 1934. The date-of-death value is sometimes referred to as a "uniform" basis because it is controlling whether the property is sold by the decedent's executor, a trustee under a testamentary trust, a remainderman (as in Helvering v. Reynolds), or a legatee. A similar "uniform basis" rule is applicable to property received by gift, Regs. §1.1015-1(b). For some of the problems that arise when two or more persons (e.g., a life tenant and a remainderman) possess interests in inherited property, see Chirelstein, Some Aspects of Basis and the Proposed Regulations, 35 Taxes 151 (1957); *infra* page 507.

4. *Life Insurance*

Section 101(a)(1) excludes the proceeds of a life insurance policy, paid by reason of the death of the insured, from gross income, a principle that was carried forward from §22(b)(1) of the 1939 Code. Important changes were made in 1954, however, in the treatment of interest paid by the insurance company where the proceeds of the policy are not paid in a lump sum.

Section 101(a)(2), like its predecessor §22(b)(2) of the 1939 Code, ordinarily denies the exclusion if the policy was transferred for a valuable consideration.

JAMES F. WATERS, INC. v. COMMISSIONER
160 F.2d 596 (9th Cir. 1947)

Before GARRECHT, HEALY, and BONE, Circuit Judges.

HEALY, Circuit Judge. . . .

The taxpayer is a dealer in automobiles. In 1938 it acquired certain insurance policies written on the life of its president, who was also its principal stockholder, these policies having been originally taken out by the president in his own right. In 1935 the insured had transferred the policies to another corporation which he controlled, in consideration of their aggregate cash surrender value less the current premiums. In 1938 the transferee corporation merged with the taxpayer and the policies became the latter's property by operation of law. Neither party to the merger recognized any gain or loss thereon. Taxpayer failed to pay premiums becoming due in 1939, and the policies, in conformity with their provisions, became converted into various forms of term insurance. Upon the death of the insured in 1941 taxpayer received a sum in excess of $141,000 upon the policies but did not report the proceeds in its returns. In determining the deficiencies the Commissioner arrived at the taxable net proceeds by deducting all sums paid as premiums since the original transfer, the amounts paid for the policies when originally transferred, and an additional credit unnecessary to describe.

Taxpayer contends that it is entitled to the benefit of [§101(a)(1)], excluding from gross income amounts received under a life insurance policy paid by reason of the death of the insured. Section [101(a)(2)], under which the deficiency in income tax was assessed, is said to be inapposite. This subdivision provides that in the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance contract, only the actual value of such consideration and the amount of the premiums and other sums paid by the transferee shall be exempt from taxation under [§101(a)(1)]. Taxpayer points to [§161(a)(2)(A)] which in substance provides that the provision above summarized shall

not apply if the insurance contract has a basis for determining gain or loss in the hands of a transferee determined by reference to such basis thereof in the hands of the transferor.* We think the sentence is not here relevant. The common sense of the limitation and its legislative history alike indicate that the limitation is to be effective only if the transfer by the *original owner* of the policy was one in which the transferee took the transferor's basis — a situation not obtaining here.[1] Had the first transferee collected on the policies the net proceeds would have been includable in gross income; and taxpayer stands in the shoes of its transferor.

As an alternative the taxpayer claims that [§101(a)(2)] is inapplicable because of the lapse of the policies in 1939 for nonpayment of premiums. The argument proceeds on the assumption that the policies were not thereafter the same contracts as those transferred. The assumption is groundless. No new contracts came into existence. The changes in the periods and amounts of insurance were effected by the terms of the insurance contracts as written in the first instance.

As to two of the policies taxpayer argues that they had no cash surrender value when originally transferred, hence their transfer was not for a valuable consideration. However, the value of an insurance policy to the holder is not confined to its cash surrender value; and the record discloses that, in addition to the payment of the surrender value of the remaining policies, a general assignment of all the policies was contemporaneously made by the insured for a recited consideration of ten dollars. There was no direct attempt below to impeach the verity of the recital,† and such evidence as there is on the point is equivocal and inconclusive.

The final argument on this phase is that the insurance proceeds constitute an indemnification of the taxpayer for the loss of its president, and are not income within the intendment of the Sixteenth Amendment. Eisner v. Macomber, 252 U.S. 189, is relied on as authority. While that decision has displayed an unexpected vitality within the limits of its particular facts, the lower federal courts would hardly be justified in extending its doctrine to wider fields. We do not doubt the power of Congress to tax life insurance proceeds as income under the limitations prescribed by this statute. Compare United States v. Supplee-Biddle Co., 265 U.S. 189, 195.[2]

NOTE

1. *Transferees of life insurance policies.* As the court points out, §101(a)(2)(A) (permitting a transferee for a valuable consideration to claim the exclusion if the contract has

* Because the taxpayer corporation had acquired the policies in 1938 in a statutory merger, its basis for them was the same as their basis in the hands of the merged corporation. But the merged corporation had acquired them in 1935 from the insured for their cash surrender value, so that *its* basis was not determined in whole or in part by reference to his basis. — ED.

1 The limitation seems to have been enacted to avoid inequitable results such as those occurring in King Plow Co. v. Commissioner, 5 Cir., 110 F.2d 649, and Stroud & Co. v. Commissioner, 45 B.T.A. 862. Compare result in Hacker v. Commissioner, 36 B.T.A. 659.

[In the King Plow Co. and Stroud & Co. cases, the "transfer for valuable consideration" provision was applied to successor corporations that had received the insurance policies in corporate reorganizations. — ED.]

† In Haverty Realty & Investment Co. v. Commissioner, 3 T.C. 161 (1944), the taxpayer successfully rebutted a formal recital of consideration in a transfer of insurance policies from one corporation to another controlled by the same shareholders, with the result that the "transfer for valuable consideration" restriction was held inapplicable. — ED.

2 For cases in which, without discussion of the constitutionality of the statutory provisions, taxpayers were in analogous circumstances required to include in gross income the proceeds of life insurance policies, see cases cited in footnote 1, supra. Consult also Lambeth v. Commissioner, 38 B.T.A. 351; E. T. Slider, Inc. v. Commissioner, 5 T.C. 263; Premier Products Co. v. Commissioner, 2 T.C. 445.

a "substituted basis" in his hands) was enacted to overrule several judicial decisions which had held that a transfer of a contract by a corporation to its successor in a merger made the proceeds ineligible for the exclusion of §101(a)(1), despite the continuing economic interest of the shareholders of the merged corporation. The result in the *James F. Waters, Inc.* case also met with Congressional disapproval: see §101(a)(2)(B), enacted in 1954 as a substitute for a more drastic proposal to eliminate entirely the "transfer for valuable consideration" restriction. The following extract from the Senate Report on the 1954 Code explains the 1954 amendment:

> Under present law life-insurance proceeds payable by reason of death are exempt from tax. However, where an insurance contract is transferred for a valuable consideration, only the actual value of the consideration and subsequent premiums paid by the transferee are tax exempt and the balance is taxable as income. The House bill grants full exemption to life-insurance proceeds payable at death where the contract is transferred for a valuable consideration.
>
> Your committee believes that the procedure in the House bill may result in abuse in encouraging speculation on the death of the insured and therefore has reinstated present law with respect to contracts transferred for a valuable consideration. However, it is made clear that complete exemption is to be granted to life-insurance proceeds paid under contracts which have been transferred for certain legitimate business reasons rather than for speculation purposes. [S. Rept. No. 1622, 83d Cong., 2d Sess. 14.]

Does §101(a)(2)(B) effectively distinguish between transfers for "legitimate business reasons" and transfers for speculation?

Note that no exemption from the "transfer for valuable consideration" restriction was required for transfers of insurance policies by gift or bequest, since no consideration is paid for such transfers.

2. *Interest when payment of principal sum is postponed.* For some years, the Code has provided that if the proceeds of a policy are held by the insurance company "under an agreement to pay interest" to the beneficiary, the interest is taxable and only the principal qualifies for the exclusion. In Commissioner v. Pierce, 146 F.2d 388 (2d Cir. 1944), it was held that this provision, now §101(c), applies only if the principal sum is held intact by the insurer for a period of time; if the principal sum is to be paid to the beneficiary in installments, the interest component of the installment payments was held to be tax-free to the beneficiary even though the installment option was elected by him rather than imposed on him by the insured. In 1954, however, Congress enacted §101(d), under which the interest component of such post-death payments is taxable to the beneficiary — subject to a $1000 annual exemption for the insured's surviving spouse.

3. *Interest "embedded" in principal sum payable.* If the life insurance policy is an ordinary life policy, rather than term insurance, part of each year's premium is for pure insurance protection and part constitutes savings on which a return is earned. If the insured had purchased term insurance, the premium on which is less because there is no element of savings, and had deposited the balance in a savings account, the interest credited to the account would be taxed to him during his life. The interest component of "ordinary" life insurance, however, is taxed neither to the insured when it is earned nor to the beneficiary when it is paid. Section 101(d), in other words, applies only to the interest earned on the proceeds after the insured's death, not to the part of the proceeds that is attributable to earnings during his life.

In The Case Against the Case for Term Insurance, Fortune 230 (Sept. 1963), the effect of excluding the interest component of life insurance from gross income is summarized as follows:

> The chart at the left [omitted] shows the cumulative cost of two $10,000 policies to an individual who is thirty-five when they are first taken out. On the whole-life policy he pays a total of $4,758 in premiums, but this cost can be reduced by $1,410 if he lets his dividends accumulate, leaving a net cost of $3,348. On the term policy, the net premium cost is $1,146 — a difference of $2,202, or about $111 a year. The chart at the right [omitted] shows that the individual who pays the extra premium will have

> $3,898 [in cash surrender value] at the end of twenty years, and there is virtually no tax on this. To accumulate the same amount by investing $111 a year during that period, he would have to earn 5.1 percent on his money, and any such earnings would be fully taxed either as dividends or as capital gains. Even if he could count on earning an average of 8 percent, all in the form of capital gains, he would be only a little better off than with whole life. An 8 percent return on $111 a year would give him $5,600 after twenty years, but for anyone in the 50 percent (or higher) tax bracket the capital-gains tax would reduce this amount to $4,760.

See Goode, Policyholders' Interest Income from Life Insurance Under the Income Tax (Brookings Institution, 1963).

4. *Tax effect of surrendering policy.* If a life insurance policy is surrendered, the tax status of the cash surrender value is governed by §72(e)(1): the excess of the cash value over the premiums paid is taxable. Is there any reason why the interest which is earned by the investment component of the premiums should be taxed if the policy is surrendered at a profit but excluded if the proceeds of the policy are paid to the beneficiary when the insured dies?

The proceeds of a matured endowment policy (unless paid as an annuity) are also taxed like the cash surrender value of a life insurance policy, that is, the excess of the amount received over the premiums paid is taxable. Why are the earnings on such a contract not excluded in the same manner as the interest component of the proceeds of a life insurance policy?

5. *Annuities*

Section 72 of the 1954 Code, governing the tax treatment of payments under annuity contracts, is a complete revision of its predecessor, §22(b)(2) of the 1939 Code. The case that follows, decided under the old Code, illustrates one of the reasons for the changes.

EGTVEDT v. UNITED STATES
112 Ct. Cl. 80 (1948)

LITTLETON, Judge, delivered the opinion of the court:

Plaintiff purchased four annuities in 1937 for $25,000 each, or a total of $100,000, entitling him to aggregate monthly payments of $407, or $4,884 a year, for the balance of his life. Each contract provided that in case of plaintiff's death prior to the receipt by him of a sum equal to the total premium paid, a further sum equal to the balance of the premium would be paid to his wife or to his estate.

Plaintiff seeks to recover income tax deficiencies and interest assessed and collected for 1938 and 1939 on account of the exaction of a tax on a portion of the annuity payments received in those years, on the asserted ground that Section 22(b)(2) of the [1939 Revenue Code] is unconstitutional. In each of the years mentioned the Commissioner of Internal Revenue, pursuant to the explicit requirements of Section 22(b)(2) of the [1939 Revenue Code] . . . , required that of the annuities totaling $4,884 received under the contracts, the amount of $3,000, being an amount equal to 3 per cent of the consideration paid for the annuity contracts, be included in gross income. Plaintiff paid the deficiencies and interest assessed and his claims for refund thereof were rejected.

It will be seen in this case that, as in other cases where the treatment of annuity payments for tax purposes has received judicial attention, the plaintiff has been required to include in gross income the annuity payments received in each year to the extent of an amount equal to 3 per cent of the aggregate consideration paid

for the annuity contracts, undiminished by any payments made to the annuitant in prior years in excess of such percentage amount. Therefore, so long as Section 22(b)(2) remains unchanged, the plaintiff, aged 45 and with a normal life expectancy, on the basis of mortality tables, of about 28 years at the time he purchased the annuities in August 1937, will be required to include in income not only $3,000 of the $4,884 received in each of the years 1938 and 1939, but a like amount in each of the subsequent years of his life, notwithstanding approximately 53 years (100,000 ÷ 1,884) will be required, on the basis of such table, for the annual amounts received by plaintiff in excess of $3,000 to aggregate the sum of $100,000 paid for the annuity contracts.

Plaintiff takes the position that the taxing of $3,000 of the $4,884 received by him in each of the years 1938 and 1939 (at which times he had received only a small fraction of the amount he had paid for the annuity policies), necessarily constitutes taxation on an amount which was not income within the meaning of the Sixteenth Amendment, and that insofar as the Revenue Act directs or permits such taxation it is unconstitutional because the tax attempted to be imposed is a direct tax on property without the apportionment required by Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4, of the Constitution.

Plaintiff first contends that the full amounts of the annuities received by him in 1938 and 1939 were nothing more than the return to him of a portion of the capital, invested in the purchase of the annuities, and hence that until the full purchase price of the annuities of $100,000 has been returned to him, the tax imposed by Section 22(b)(2) is a tax upon capital and not upon income derived from capital. The evidence offered by plaintiff falls far short of supporting this contention. . . .

The evidence shows that from the standpoint of an insurance company each payment represents in part interest on the investment. We cannot, therefore, say that such part is capital, and nontaxable, in the hands of the annuitant. Klein v. Commissioner, 6 B.T.A. 617; Guaranty Trust Co. v. Commissioner, 15 B.T.A. 20 . . .

Plaintiff next contends that even if it be conceded that some part of each annuity payment was income and, therefore, subject to be taxed, the amount arbitrarily designated by the statute for inclusion in gross income cannot be reconciled with the best evidence available as to what portions of the annuity payments received by him in 1938 and 1939 were, and what portions of the payments received in the future will be, gain derived by plaintiff from his investment of capital in the annuity policies. This contention is based primarily upon the American Annuitants' Male Select Table of Mortality, rated down one year, under which the probability, in August 1937, that plaintiff would survive another 53 years was less than one-half of one per cent. Such mortality tables are used by insurance and annuity companies in determining rates of insurance and annuities for certain groups of people. They are based on a limited number of lives and, while reliable in connection with certain determinations, we think such evidence is not determinative of the question presented. We cannot accept such evidence as sufficient, standing alone, to establish the fact that a substantial portion of the annuity payments received by plaintiff did not constitute income, nor as sufficient evidence to show that the action of Congress in fixing, after a full investigation, the measure of the taxable income in connection with receipt of such annuities was without foundation, wholly arbitrary and, therefore, void under the Sixteenth Amendment. Cf. Helvering v. Midland Mutual Life Insurance Co., 300 U.S. 216. . . .

The provision . . . with which we are here concerned was first enacted in the Revenue Act of 1934 (48 Stat. 680). In its report on H.R. 7835, which became the Revenue Act of 1934, the Ways and Means Committee of the House of Rep-

resentatives gave the following explanation of its investigations and conclusions in support of the change . . . :

Section 22(b)(2). Annuities, etc.: The present law [pre-1934] does not tax annuities arising under contracts until the annuitant has received an aggregate amount of payments equal to the total amount paid for the annuity. Payments to annuitants are, in fact, based upon mortality tables which purport to reflect a rate of return sufficient to enable the annuitant to recover his cost and in addition thereto a low rate of return on his investment. The change continues the policy of permitting the annuitant to recoup his original cost tax-free but requires him to include in his gross income a portion of the annual payments in an amount equal to 3 per cent of the cost of the annuity. While the per cent used is arbitrary, it approximates the rate of return in the average annuity.

Statistics show that an increasing amount of capital is going into the purchase of annuities, with the result that income taxes are postponed indefinitely. The change merely places the return of this form of investment on the same basis as other forms of investment by taxing that portion of each payment which in fact constitutes income.

Thus the formula employed by Congress in Section 22(b)(2) for taxing a portion of the payments received from the investment of funds in annuity contracts does not purport to directly charge with a tax the source from which the payments are derived. On the contrary, as stated in Manne v. Commissioner, 155 Fed. (2) 304, at 307,

Congress, in providing that the return from such annuity contracts should be included in the annuitant's gross income to the extent of three per cent of the sum invested by the annuitant, may be said to have made an approximation of that portion of the annuitant's return which is received by him in the form of income from the capital invested.

In holding that the taxpayer in the *Manne* case was, under the facts in that case, in no position to question the constitutionality of Section 22(b)(2) the court stated, at page 307:

. . . A taxpayer claiming that the section of the Revenue Code in question imposes in a given case a tax upon the return of capital under the guise of a tax on income is under the burden of establishing that no income was in fact received by him from his investment, or at least that the income actually received is less than three percent upon his investment. In this case there is no evidence to show that the earnings on the taxpayer's investment were less than three per cent of its amount during the taxable years in question, or to support the inference that the payments received by him were wholly or even partly a return of capital. . . . A taxpayer alleging unconstitutionality of an act must show not only that the act is invalid, but that he has sustained some injury as a result of its enforcement.

With the above-quoted statement of the court in mind, plaintiff now urges that under the facts presented in this case he has sufficiently sustained the burden of proof suggested in the *Manne* case, to show that Section 22(b)(2), to the extent that it undertakes to define as income and tax without apportionment $3,000 of his annual annuity payments, is unconstitutional as imposing a tax on property which is not income.

We cannot agree, for the reasons already stated, that plaintiff has sufficiently sustained the burden of proof which rests upon him. Moreover, we cannot determine from anything in the evidence what part of the payments periodically made to plaintiff during the taxable years actually represents earnings on the amounts paid by him as consideration for the policies and what part was simply a return of capital. Conceivably, so far as the evidence shows, the earnings on plaintiff's investment may have been, from the standpoint of the insurance companies, adequate to cover those portions of the 1938 and 1939 payments on which the tax in question was imposed. . . .

The weakness of plaintiff's argument lies in the premise that the taxpayer is

constitutionally guaranteed the full return of whatever sums he may invest before any part of the proceeds from his investment may be taxed as income, and that until this is assured Congress does not possess the power to designate as income subject to tax without apportionment, any receipts from his invested property which may in the course of events prove to have been derived from the property itself. Cf. Peabody v. Eisner, 247 U.S. 347; Stanton v. Baltic Mining Co., 240 U.S. 103.

The view we have taken with respect to plaintiff's premise as a ground for declaring an act of Congress to be unconstitutional is not, in our opinion, contrary to the generally accepted view that in the cases of sales of property the capital must be returned before there is any income to be taxed by way of profit, nor to anything which was said by the court in Burnet v. Logan, 283 U.S. 404. In that case the court was not deciding the question of whether the income statute involved sought to impose a tax beyond the constitutional power of Congress, but rather the question whether, under the applicable provisions of the statute before the court, certain receipts from a sale were taxable in part as capital. In stating, at page 414, that

> If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment.

the court quite obviously was speaking of the situation as it would have existed under the Revenue Act of 1916, wherein amounts received as a return of premiums under annuity contracts were excluded from gross income.

Notwithstanding the absence of any showing of a certainty that Section 22(b)(2) levies a direct tax on capital, the plaintiff, on the strength of what was said in Burnet v. Logan, supra, and on the basis of the definition of "income" given in Eisner v. Macomber, 252 U.S. 189, 207, would have us treat the annuity payments to him as, in effect, piecemeal sales of his annuity investments, or as a gradual conversion of a capital asset from one form to another, so as to make it necessary to measure out the return of capital before arriving at any amount as gain derived therefrom. However, we think an investment of funds in an annuity is a transaction which is materially different from an ordinary business transaction entered into for profit where the concept of gain or loss might be applicable. To some extent one who has invested his money in an annuity may be said to have "spent it," that is, to have parted with it in order to obtain contractual rights which are not inherent, in the same degree at least, in the mere ownership of property.

> Elements of value other than the right to receive payments for life are present in an annuity, e.g., security, assurance of income, regularity of payments and relief from responsibility of attending to investment. The experience which actually develops for the annuitant, whatever that may be, extinguishes both the annuity's cost and its expected returns as a capital investment. [Evans v. Rothensies, 114 Fed. (2d) 958, 961.]

We are unwilling to say that the view of Congress, as indicated by the Committee reports on the enactment in question, that a substantial portion of amounts received under annuity contracts represents income and its finding as expressed in the statute that 3 per cent of such annual payments is a fair approximation of the income in the average annuity, were without foundation. . . .

NOTE

1. *Current treatment of annuities.* The taxation of annuities was completely revised by §72 of the 1954 Code. The basic principle of this provision can be illustrated by two examples.

Assume that $10,000 in premiums was paid for an annuity contract, and that upon maturity of the policy the obligor is to pay $1000 annually for 15 years to the annuitant or, should he not survive, to his estate. Under §72, two thirds (i.e., $10,000 "investment in the contract" divided by $15,000 "expected return") of each payment would be excluded from income, and the balance would be taxable. Over the contract period, the cost of the contract would be recovered tax-free, and the rest would be taxed.

If the obligor under the contract promised to pay $1000 annually for life to the annuitant, instead of guaranteeing payment for a specified number of years, the "expected return" would be calculated by reference to the annuitant's life expectancy on the annuity starting date. Assuming that his expectancy was then 18 years, the amount to be excluded from income would be 10/18 (i.e., $10,000 "investment in the contract" divided by $18,000 "expected return") of each payment. Note that in such a situation the amount to be excluded from income over the annuitant's life might be either more or less than the contract's cost. Short-lived annuitants can lose out under the new rule as they could under the 3 per cent rule; long-lived annuitants, who could never exclude more than cost under the 3 per cent rule, now get a chance to beat the government, though this may be of little comfort to those who lose.

In application, §72 may be more complicated than the examples given above. Adjustments will be necessary if (a) amounts have been received under the contract that were tax-free under prior law or under other sections of the 1954 Code, (b) the contract provides for payments that are related to the annuitant's life expectancy but also guarantees that a specific amount will be paid in any event ("refund annuities"), (c) there is more than one annuitant ("joint and several annuities"), or (d) the contract was transferred for a valuable consideration.

An attack on the constitutionality of the 1954 legislation, similar to the unsuccessful attack in the *Egtvedt* case, failed in Waller v. Commissioner, 39 T.C. 665, 678-680 (1963).

2. *Employee annuities.* By virtue of §72(f)(1), the annuitant can include as part of his "investment in the contract" any premiums paid by his employer for the contract, if the payments were includible in his income. See the *Drescher* case, supra page 36; §403(b).

3. *References.* See The Income Tax Treatment of Pensions and Annuities, by the Division of Tax Research, Treasury Department, reprinted in Hearings Before the House Ways and Means Committee, 80th Cong., 1st Sess., on Proposed Revision of the Internal Revenue Code, 1947, Part 5, pp. 4001-4004.

6. *Compensation for Personal Injuries or Sickness*

Section 22(b)(5) of the 1939 Code excluded from gross income compensation for personal injuries or sickness, whether received as damages, as workmen's compensation, as health or accident insurance, or as a military pension or annuity.

Section 104 of the 1954 Code re-enacts §22(b)(5), except as to amounts received by an employee through health or accident insurance attributable to contributions by the employer that were not includible in the employee's gross income. Such amounts are taxed to the employee unless they meet the requirements of §105 of the 1954 Code, which has no counterpart in the 1939 Code.

SIMMS v. COMMISSIONER
196 F.2d 238 (D.C. Cir. 1952)

Before EDGERTON, WILBUR K. MILLER and FAHY, Circuit Judges.

FAHY, Circuit Judge.

Petitioner Joseph B. Simms seeks reversal of a decision of the Tax Court of the United States to the effect that he owes a deficiency of income tax for the year 1945 in the sum of $572.71. His position is that the income which resulted in the tax was in legal contemplation received for physical disability incurred in the line of duty as a member of the Fire Department of the District of Columbia.

Accordingly, he contends, it was no part of his taxable income because [§104(a)(1)] exempts amounts received "under workmen's compensation acts, as compensation for personal injuries or sickness." The respondent, Commissioner of Internal Revenue, ruled that the income was paid to petitioner as a result of his retirement for age and not for disability. If this is right there is no controversy the deficiency is due. The Tax Court agreed with the Commissioner that petitioner was retired for age and therefore his retirement pay is not attributable to disability.

The District of Columbia Code provides that firemen may be retired with compensation to be paid from the Policemen and Firemen's Relief fund (1) by reason of permanent disability incurred in line of duty, or (2) after twenty-five years' service, under certain conditions, or, (3) having reached the age of sixty years, in the discretion of the Commissioners.

Petitioner was retired under an order of the Board of Commissioners of the District, dated January 31, 1942, reciting that he and others of the Fire Department, "having reached or passed the age of 64 years" are retired, and "are granted relief . . . payable from the Policemen and Firemen's Relief of the District of Columbia. . . ." Petitioner's relief was stated to be the sum of $187.50 per month, which petitioner states was 50% of his salary, in which event it was the maximum permitted by law. §4-507, D.C. Code (1940). On April 20, 1948, the Commissioners by a further order recited that at the time of his retirement petitioner, and others,

> were suffering from physical disabilities which were incurred in the line of duty to such an extent that had they not been retired when they were, for age, they would have been retired for physical disability incurred in the line of active Fire Department duty. . . .

It appears independently that prior to retirement petitioner had suffered physical disability in line of duty. The extent of this disability, however, except that it was permanent, has never been ascertained or translated by administrative action into an award of compensation or retirement pay for disability. See footnote 1, infra.

Notwithstanding that both the 1942 and 1948 orders make clear that petitioner was retired not for disability but for age, he contends that since he had become permanently disabled it was the duty of the Commissioners to retire him for disability under §4-507, D.C. Code (1940).[1] Therefore, he continues, a vested right to disability retirement accrued and the determination made in connection with his retirement that he should receive 50% of his salary is in legal effect an award of that amount for disability. We are unable to accept this view for two reasons. In the first place there has been no determination by the Commissioners of the extent of disability as a basis for fixing an amount of relief for disability. See Waller v. United States, 1950, 180 F.2d 194. In the second place, even though, as petitioner argues, the Federal authorities are not bound by the interpretation of the situation made by the District authorities, namely, that he was retired for age, nevertheless it is our view that the correct interpretation for Federal purposes is that petitioner was retired for age. Therefore the income he received as a consequence was not paid to him "under workmen's compensation acts, as compensation for personal injuries or sickness," [1954 Code, §104(a)(1)], and is not

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[1] This section reads in pertinent part:

"Whenever any member of the . . . fire department of the District of Columbia shall become so permanently disabled through injury received or disease contracted in the line of duty as to incapacitate him for the performance of duty . . . , he shall . . . be retired from the service thereof and be entitled to receive relief from the said policemen and firemen's relief fund, District of Columbia, in an amount not to exceed 50 per centum per year of the salary received by him at the date of retirement. . . ."

excludable from his gross income in the process of arriving at his Federal income tax.

Affirmed.

NOTE

1. *Disability vs. age as the basis of retirement.* In Allen v. Spencer, 214 F.2d 205 (D.C. Cir. 1954), a group of retired District of Columbia police and firemen sued the District Commissioners to substitute for their retirement orders based on age and length of service, new orders based on disability. The court held that any objections to the original orders should have been made in accordance with the prescribed administrative procedures when the orders were issued. In Prince v. United States, 119 F. Supp. 421 (Ct. Cl. 1954), the court held that military retirement pay received by an army officer came within §104(a)(4) of the 1954 Code, where he could have been retired on the same pension for disability in line of duty. Apparently he had chosen (in 1943) to be retired for age so as to be eligible for recall to active duty, whereas a disability retirement would have barred a return to duty.

2. *Is §104(a) necessary?* In view of the rulings and decisions supra pages 79 et seq., on the status of amounts received as compensation for a loss of "personal rights," does §104(a) merely restate the obvious, or does it permit the exclusion of amounts that are not immunized by the rulings and cases? If an injured person recovers a lump sum from a tort-feasor for physical injury, pain and suffering, and loss of past and future earnings, is the entire amount excluded from income by §104(a)? What about a recovery by a husband for loss of corsortium or by a parent for loss of a child's earning capacity?

See Starrels v. Commissioner, supra page 82, on the status of a payment paid in advance of a personal injury for the "victim's" consent to and release of liability for the injury.

Do punitive damages imposed on a reckless or willful tort-feasor qualify for the exclusion of §104(a)?

3. *Reimbursement of deductible medical expenses.* The significance of §104's introductory clause, relating to §213, will become apparent when §213 is encountered, infra page 170.

KAUFMAN'S ESTATE v. COMMISSIONER

35 T.C. 663, (1961), affirmed per curiam, 300 F.2d 128 (6th Cir. 1962)

Bruce, Judge: This proceeding involves a deficiency in income tax for the year 1955 in the amount of $1,255.89. The sole issue is whether an amount of $5,200 is properly excludible as "sick pay" under section 105(d), I.R.C. 1954.

[Findings of fact omitted.]

After suffering a stroke in June 1953 decedent did not return to his job as managing officer of the Louisville Home Federal Savings and Loan Association, but continued to receive the same annual salary until his death in January 1958. During the year 1955 decedent received the sum of $8,700 from his employer, of which amount decedents* excluded $5,200 from their gross income as "sick pay." Respondent has determined that said amount of $5,200 does not qualify for the sick pay exclusion under section 105, I.R.C. 1954.

Section 105(a) provides that amounts received by an employee through accident or health insurance for personal injuries or sickness are includible in his gross income to the extent that such amounts are attributable to contributions by the employer which were not includible in the gross income of the employee, or are paid by the employer, unless such amounts are excluded from gross income by section 105(b), (c), or (d).

* Following the husband's death in 1958, his wife died, and the case was prosecuted by their executors. — Ed.

Under the provisions of section 105(d), wages or payments in lieu of wages received by an employee through accident or health insurance for a period during which the employee is absent from work on account of personal injuries or sickness are excludible from gross income, subject to certain limitations which are not here under contention. For purposes of section 105(d) amounts received under an accident or health plan for employees are treated as amounts received through accident or health insurance. Sec. 105(e).

For wage continuation payments to an employee to qualify for the sick pay exclusion provided by section 105(d), such payments must be received by the employee: (1) Through accident or health insurance or under an accident or health plan for employees, (2) for a period during which the employee is absent from work on account of personal injuries or sickness.

Respondent's position is that petitioners have failed to meet their burden of proving that the amounts received by decedent in 1955 from the association were received in accordance with the terms of an accident or health plan of the association, or that the decedent's absence from work in 1955 was due to a personal injury or sickness.

There is considerable doubt whether an accident or health *plan* existed within the meaning of section 105. We are not unmindful of the liberalizing intent indicated by the legislative history of that section. See, generally, Comment, "Taxation of Employee Plans," 64 Yale L.J. 222 (1954). Likewise, a liberal construction is evidenced by the Treasury regulations promulgated under section 105 which speak in terms of an "arrangement" and "program, policy, or custom having the effect of a plan." Sec. 1.105-5. However, the recurrent statutory use of the term "plan" or "plans," as well as the comment in the Senate Finance Committee's report (S. Rept. No. 1622, 83d Cong., 2d Sess., p. 185 (1954)), that section 105, as adopted, "specifies that the exemption is to be granted only to benefits paid out under an arrangement which constitutes a plan," indicates that the use of "plan" signifies something more than merely one or more ad hoc benefit payments. Had Congress intended to exclude from gross income all ad hoc benefit payments arbitrarily made at the complete discretion of the employer in the absence of any sort of prior arrangement or practice, the use of the term "plan" would scarcely have been necessary.

The evidence that the association had an arrangement or plan for the payment of sick pay to its employees is, to say the least, meager. Burkholder, the managing officer of the association, in answer to the question, "Did your company have any policy or plan with respect to sick pay of its employees?" testified: "It's always been the policy of our board or the Association to continue the pay of employees when they are ill." He testified to only one other specific instance, however, where payments were made to a sick employee and apparently that occurred after decedent's stroke, since Burkholder made the arrangements. We are not convinced that this testimony, without more, is sufficient to establish that a "plan" existed within the meaning of section 105.

In any event, petitioners have not, in our opinion, established that the payments in question were made pursuant to any accident or health plan it may have had. After his stroke decedent continued as an officer of the association until his death, as executive vice president and treasurer. He also served as chairman of the board of directors. Although he visited the office of the association only once after his stroke, he was frequently consulted as to the affairs of the association. From the time of his stroke until at least a couple of months before his death, Burkholder visited decedent from once a week to two or three times a month to discuss association business. The letter which the association's board of directors sent to the decedent after his stroke evidences an intent to retain the

benefit of his advice, business acumen, and prestige. It speaks in terms of retaining and commanding decedent's services and states that "Regardless of your present incapacity to attend meetings it is the desire of the Board that you remain one of its active members and your consultation on vital matters should always be at the command of the institution's officers and directors."

In our opinion, the payments in question constituted compensation for decedent's services. It is true that, after his stroke, decedent no longer served the association full time. However, as the organizer and long-time managing officer of the association, his counsel and advice were undoubtedly valuable to the association. As was stated in Smoky Mountain Beverage Co., 22 T.C. 1249, 1254, "A part-time officer, having exceptional ability, wide contacts, and a reputation for financial responsibility, might well be worth more to a corporation than a full-time officer lacking these desired qualities." See also Miller Mfg. Co. v. Commissioner, 149 F.2d 421.

Considering the evidence as a whole, we hold that petitioners have not established that any part of the payments made to decedent in the year 1955 is excludible from gross income under the provisions of section 105(d).

Decision will be entered for the respondent.

NOTE

1. *Background of §105.* Before 1954, the status of wage continuation payments received by a sick employee depended upon whether they constituted "amounts received through accident or health insurance for personal injuries or sickness" as this phrase is used in §104(a)(3). (The parenthetical limitation of §104(a)(3), as well as §§105 and 106, was not added until 1954.) Under pre-1954 law, the Court of Appeals for the Seventh Circuit held in Epmeier v. United States, 199 F.2d 508 (7th Cir. 1952), that an elaborate wage continuation plan for the employees of a life insurance company was "accident or health insurance," and this interpretation of pre-1954 law was endorsed by the Supreme Court in Haynes v. United States, 353 U.S. 81 (1957), involving the employees of the Southern Bell Telephone & Telegraph Company. Fearful that the *Epmeier* case would encourage closely held corporations to allow their executives and shareholder-employees to go to Florida on "sick leave" every winter without reducing their regular compensation, the Internal Revenue Service announced in 1953 that it would not follow *Epmeier* "in the absence of further clarification from the Congress." Congress responded in 1954 by adding the parenthetical restriction to §104(a)(3), and by enacting §§105 and 106.

Section 105(b), (c), and (d) sets out the extent of the exclusion of amounts received through health or accident insurance, if paid by the employer or attributable to contributions by him that were not includible in the employee's gross income. Amounts that are not within these exclusions are taxable, §105(a). But what is the relation between §105(a) and §104(a)(2)?

The "sick pay" exclusion of §105(d) was somewhat restricted in 1964 by reducing the amount that qualifies for exclusion from $100 per week to $75 in certain circumstances, and by increasing the waiting period.

With *Kaufman's Estate,* cf. Andress v. United States, 198 F. Supp. 371 (N.D. Ohio, 1961) (on a change in management, decedent's employer agreed to pay him and his brother $15,000 a year for life, whether they worked or not and regardless of their health, in exchange for relinquishing rights under a profit-sharing plan; decedent received the agreed salary for a 5-year period during which he was totally incapacitated by illness; held, payments qualify for exclusion under §105(d) even though no other employees were included in the "plan").

2. *Payment received after retirement age.* See Regs. §1.105-4(a)(3)(i), providing that wage continuation payments qualify for the exclusion of §105(d) until the normal retirement age, but not thereafter, because the employee is no longer "absent from work on account of personal injuries or sickness." This limitation is discussed in Commissioner v. Winter, 303 F.2d 150 (3d Cir. 1962). involving a retirement scheme under which retire-

ment was optional with the employee at 60 but compulsory at 65; see also Corkum v. United States, 204 F. Supp. 471 (D. Mass. 1962). Note that disability pensions that qualify under §104(a)(1) (workmen's compensation), §104(a)(2) (damages), or §104(a)(4) (military, etc., pensions) may be excluded from gross income regardless of amount or duration.

3. *Employer's contributions for accident or health plans.* Note that §106 does not discriminate between amounts paid by an employer for individual accident and health insurance policies and amounts paid for group policies. Previously, the Internal Revenue Service took the position that payments for individual policies constituted additional compensation to the employees, but that payments for group policies did not.

4. *Employee death benefits.* Recall that §101(b) exempts "employee death benefits" up to $5000 per employee. Supra page 131. If such benefits are paid pursuant to a formal plan, could they be treated as "amounts received . . . under a life insurance contract," so as to be exempt under §101(a)(1) regardless of amount? In Moholy v. United States, 235 F.2d 562 (9th Cir. 1956), the court argued that §101(b) was necessary because such death benefits did not constitute "insurance," and relied on this analogy in arriving at the conclusion that a similar provision would be necessary to exempt sick leave benefits. But the Supreme Court in the *Haynes* case, supra paragraph 1, adopted a more expansive view of the term "accident or health insurance." Does this presage a similarly liberal view of the term "life insurance"?

5. *References.* Pyle, Accident and Sickness Insurance Under Code Sections 104, 105, 106, and 213, 34 Taxes 363 (1956); Comment, Taxation of Employee Accident and Health Plans Before and After the 1954 Code, 64 Yale L.J. 222 (1954); Schlenger, Disability Benefits Under Section 22(b)(5), 40 Va. L. Rev. 549 (1954).

7. *Tax-free Interest and Other Intergovernmental Tax Immunities*

Section 22(b)(4) of the 1939 Code, excluding interest on federal, state, and municipal obligations from gross income, was reenacted without substantive change by §103 of the 1954 Code.

NOTE

1. *Source and economic effect of tax immunity for state and local bond interest.* Must the federal government grant an exemption for interest from state and municipal bonds? Rottschaefer, Federal Taxation of State and Municipal Bond Interest, 20 N.C.L. Rev. 141 (1942); Rakestraw, The Reciprocal Rule of Governmental Tax Immunity — A Legal Myth, 3 Okla. L. Rev. 131 (1950). If the exemption is a matter of grace, can it be defended? Note first that high bracket taxpayers can derive an unusual benefit by investing in "tax-exempts." The following table shows the rate of *taxable* income that would be required to produce a "take-home" or after-tax yield of 2, 3, 4, and 5 per cent for a married couple at various levels of taxable income under the 1965 rates:

Taxable Income *	*Rate of Return Required to Produce After-Tax Yield of:*			
	2%	*3%*	*4%*	*5%*
$24,000-28,000	3.12	4.69	6.25	7.81
$40,000-44,000	3.85	5.77	7.69	9.62
$100,000-120,000	5.26	7.89	10.53	13.16
$180,000-200,000	6.45	9.68	12.90	16.13

* Married couple filing joint return.

For the higher brackets, it is clear that no industrial or other private bonds can compete with the tax-exempts in net yield. By the same token, however, the state or municipality is enabled to sell its securities at a lower interest cost. Whether these issuers gain as much as the federal government loses is an open question. One writer has pointed out the possibility that federal taxation of state and municipal bond interest, while increasing the

progressivity of the federal tax, might cause state and municipal agencies to rely more heavily on regressive taxes or to reduce services to lower income groups. Bronfenbrenner, Economic Effects of the Taxation of Government Securities, 35 Ill. L. Rev. 293 (1940). The questions of policy were vigorously debated in 1942 before the House Committee on Ways and Means, when the Treasury campaigned unsuccessfully for a repeal of §103. Hearings on Revenue Revision of 1942, House Committee on Ways and Means, 77th Cong., 2d Sess., Vol. 2, pp. 1479-1610; Vol. 3, pp. 3079-3160; see also Hearings on H.R. 7378, Senate Finance Committee, 77th Cong., 2d Sess., Vol. 1, pp. 539-673; Simons, Personal Income Taxation 170-184 (1938). More recent discussion by several authors may be found in Tax Revision Compendium, House Committee on Ways and Means 679-791 (1959); Ott and Meltzer, Federal Tax Treatment of State and Local Securities (Brookings Institution, 1963); and a brief history of the question may be found in Lent, The Origin and Survival of Tax-exempt Securities, 12 Nat. Tax J. 301 (1959).

Butters, Thompson, and Bollinger, Effects of Taxation: Investments by Individuals (1953), after a study of the holdings of tax-exempt securities by wealthy investors, conclude (p. 298) that the tax structure provides a strong incentive for such individuals to invest in tax-exempt securities but that their holdings were (in 1949) substantially smaller than might have been anticipated:

> Among the factors responsible for the failure of top bracket individuals to exploit fully this opportunity of receiving tax-exempt income, the following appear to have been important: the failure of these securities as a class to offer much opportunity for capital appreciation in recent years; their low yield at 1949 interest rates; the specialized knowledge which is required for intelligent investments in state and local bonds; and fear of capital loss from such investments.

See also Lent, The Ownership of Tax-exempt Securities, 1913-1953 (Nat. Bureau of Econ. Res. Occasional Paper 47 (1955)).

2. *Indirect restrictions on immunity.* At several points the Code strikes indirectly at tax-exempt bonds. Interest on loans to buy or carry such securities may not be deducted, infra page 190. Other expenses (such as safe-deposit box rentals, fees for investment advice, etc.) related to such securities are disallowed by §265(1). See National Life Ins. Co. v. United States, 277 U.S. 508 (1928); Powell, The Remnant of Intergovernmental Tax Immunities, 58 Harv. L. Rev. 757, 796-803 (1945).

Moreover, it has long been established that the gain realized on a sale of tax-exempt securities is subject to income tax: Willcuts v. Bunn, 282 U.S. 216 (1931).

3. *"Industrial" municipal bonds.* In recent years there has been some use of "industrial" municipal bonds — issued to finance the construction of factories that are then rented to private industries. Often the municipality's credit is not pledged, the bonds being payable from the rentals. An unusual provision of one such issue is that the bonds may be converted by the holder into the common stock of the lessee enterprise. Can tax immunity be defended for such bonds? See Note, 66 Harv. L. Rev. 898, 904-906 (1953). Private real estate investors may find it hard to compete with real estate developments that are financed by tax-exempt bonds, especially since the rentals paid to the municipality (out of which the interest and principal are to be paid) are also tax exempt. A somewhat analogous attempt to exploit the tax exemption of charitable organizations was eliminated by the Revenue Act of 1950. See Brown, The New Restrictions on Charitable Exemptions and Deductions for Federal Tax Purposes, 13 U. of Pitt. L. Rev. 623 (1952). The House version of the 1954 Code included a provision prohibiting the deduction of rent paid for the use of property acquired or improved by the issue of so-called industrial development revenue bonds (where the credit of the issuing authority was not pledged), but the Senate would not agree and the provision was eliminated. The Conference Report states that "it is recognized that a serious abuse may be developing where the Federal income tax exemption granted interest on State and local governmental obligations is used for purposes of attracting new industry," but that the proposal might "have had the unintended result of affecting adversely certain proper governmental functions, such as the operation of municipal wharf and storage facilities, municipal airports, and similar operations." H.R. Rept. No. 2543, 83d Cong., 2d Sess. 33. See Ratchford, Revenue Bonds and Tax Immunity, 7 Nat. Tax J. 40 (1954).

4. *Salaries of public officials.* In Helvering v. Gerhardt, 304 U.S. 405 (1938), it was held that employees of the Port of New York Authority (created by a compact of New York and New Jersey, see Commissioner v. Shamberg's Estate, 144 F.2d 998 (2d Cir. 1944)) were subject to the federal income tax:

> A nondiscriminatory tax laid on their net income, in common with that of all other members of the community, could by no reasonable probability be considered to preclude the performance of the function which New York and New Jersey have undertaken, or to obstruct it more than like private enterprises are obstructed by our taxing system. Even though, to some unascertainable extent, the tax deprives the states of the advantage of paying less than the standard rate for the services which they engage, it does not curtail any of those functions which have been thought hitherto to be essential to their continued existence as states. At most it may be said to increase somewhat the cost of the state governments because, in an interdependent economic society, the taxation of income tends to raise (to some extent which economists are not able to measure, see Indian Motorcycle Co. v. United States, 283 U.S. 570, 581, footnote 1) the price of labor and materials. The effect of the immunity if allowed would be to relieve respondents of their duty of financial support to the national government, in order to secure to the state a theoretical advantage so speculative in its character and measurement as to be unsubstantial. A tax immunity devised for protection of the states as governmental entities cannot be pressed so far. [304 U.S. at 420.]

Thereafter the federal income tax was levied on all state and municipal officers and employees; at the same time Congress consented (by Title I, §4 of the Public Salary Tax Act of 1939, 53 Stat. 575) to state taxation of its officers and employees. Shaw, The Public Salary Tax Act of 1939, 27 Calif. L. Rev. 705 (1939). There has never been an attempt, however, to tax the state's *own* income. See §115. Could any part of such income be constitutionally taxed? See New York v. United States, 326 U.S. 572 (1946). Section 511(a)(B) imposes a tax on the "unrelated business income" (e.g., that derived from industrial or commercial activity) of state colleges and universities. See page 176 infra.

5. *Interest on federal obligations.* The interest on all obligations of the United States and its instrumentalities issued after March 1, 1941, when the Public Debt Act of 1941 was enacted, is fully subject to federal income tax. Some federal obligations issued before 1941 contained a covenant that the interest would be free from income taxation, however, and some of these obligations are still outstanding. Moreover, post-1941 obligations of the District of Columbia and of territories and possessions of the United States are not subject to the Public Debt Act of 1941. See Regs. §1.103-4(b).

In addition, many pre-1941 federal obligations contained a covenant that the interest would be free from the normal tax but not the surtax. At the time these obligations were issued, the federal income tax structure consisted of a normal tax at a relatively flat rate, applicable to all income above a relatively modest personal exemption, and a more steeply graduated surtax, which started at a higher income level because a higher personal exemption was granted. During this period, the surtax was thought of as a temporary tax, to be repealed when financial conditions permitted, and only the normal tax was regarded as a permanent part of the federal tax structure. But these hopes were abandoned long ago; and in 1934, the personal exemptions for normal tax and surtax were made uniform. Until 1954, however, the Code continued to distinguish between "normal tax net income" (upon which the normal tax was levied) and "surtax net income" (upon which the surtax was levied), but the only difference between the two was that partially tax-free interest on federal obligations was excluded from "normal tax net income" but included in "surtax net income." The 1954 Code achieves the same result with greater simplicity by combining the normal tax and surtax and imposing both upon "taxable income" (including partially tax-exempt interest), and then allowing a credit of 3 per cent (the normal tax rate) for such interest. §35. To satisfy the terms of the partially tax-exempt obligations, it is still necessary to designate part of the income tax as normal tax (from which the obligations are exempt) and the rest as surtax. This is done in §1(a). The consequence is that a taxpayer does not have to concern himself with the distinction between normal tax and surtax unless he has received some partially tax-exempt interest.

6. *Salaries of federal judges.* An interesting, but minor, episode in the constitutional

area is the taxability of the salaries of federal judges. The last sentence of §22(a) of the 1939 Code explicitly included all judicial salaries. (The clause was omitted from §61 of the 1954 Code as unnecessary.) Article III, Section 1 of the Constitution provides that federal judges "shall, at stated Times, receive for their Services, a Compensation, which shall not be diminished during their Continuance in Office." This injunction, it was held in 1920, prohibited the levy of a federal income tax on a judge's salary; the judge in question had been appointed in 1899, but the Court did not rest its decision on the fact that his appointment antedated the income tax. Evans v. Gore, 253 U.S. 245 (1920). The subsequent litigation on this subject is reviewed in Baker v. Commissioner, 149 F.2d 342 (4th Cir. 1945), cert. denied, 326 U.S. 746, holding that "a judge who takes office under an established Congressional policy of taxing his salary becomes entitled only to the salary prescribed by statute less income taxes . . ." Such a policy was established by Congress in the Revenue Act of 1918; the court also held that a post-1918 increase of rates, or a restoration of tax after a reduction, did not improperly diminish the salary. Evans v. Gore, therefore, could have continued vitality only for the vanishing tribe of pre-1918 judges. Referring to that case, Holmes once wrote:

> This morning brings a surprise — I was notified some time ago that prepayment of tax by companies issuing bonds counted as part of my income [see p. 185 infra] and that a small additional tax was due from me for two past years. I wrote back that I should pay as soon as I received my bill and that I didn't know it made any difference that by the decision of our court (I dissenting) I had overpaid by some thousands, as my salary was taxed. Answer comes that if I apply for a refund of it I shall receive prompt attention — I don't quite know whether to or not. The wiley [sic] Brandeis has had overpayment credited on a tax, I believe. [1 Holmes-Laski Letters 335-336 (1953).]

Judge L. Hand has also written on Evans v. Gore:

> Again I have pondered on what it is to be a Bolshevik, and once I learned. There was a time when Congress thought it could reach the salaries of my brothers and myself by an income tax, until the Supreme Court manfully came to our rescue. A judge of much experience was talking with me one day about it; I was wrong enough in my law, as it afterwards turned out, and disloyal enough in temper to my class, to say that I thought the tax valid. "Do you know anything about it?" he asked with some asperity. "No," said I, "not a thing." "Have you ever read Taney's letter? *" "No," said I again, for I was innocent of any learning. "Why, they can't do that," said he; "they can't do that, that's Bolshevism." And so it turned out, to my personal gratification, since when, freed from that Red Peril, I have enjoyed an immunity which the rest of you, alas, cannot share. [This was written in 1930.] Far be it from me to suggest that there are graver thrusts at the structure of society than to tax a Federal judge. Properly instructed, I have recanted my heresy, and yet there hangs about "Bolshevism" a residual vagueness, a lack of clear outline, as of a mountain against the setting sun; which only goes to show, I suppose, that a fundamentally corrupt nature can never be wholly reformed. [L. Hand, The Spirit of Liberty 77-78 (Dillard ed. 1953).]

Section B. Personal Deductions

Chapter 1 and Section A of this chapter have set the stage for determining the taxpayer's *gross* income. Chapter 1 demonstrates how broad is the definition of §61 and how diverse are the events that may give rise to income; it also shows that there are constitutional boundaries to what may be taxed. Section A of this chapter is concerned primarily with certain receipts that Congress has chosen to exclude from gross income, notwithstanding its power to tax them, or most of

* In 1863, Chief Justice Taney wrote to the Secretary of the Treasury to protest against an application of the Civil War federal income tax to federal judges, stating that the levy would be unconstitutional but that the question could not be decided in a judicial proceeeding because of the judges' own interest in it. 157 U.S. 701. — Ed.

them, if it chose. Both Chapter 1 and Section A of this chapter are illustrative rather than exhaustive.

Once the taxpayer's *gross* income is ascertained, it becomes necessary to tabulate his deductions in order to arrive at *taxable* income. For it is *taxable* income upon which the tax itself is levied.

In listing the taxpayer's deductions, the student should always keep in mind that deductions are permissible only when authorized by statute or regulations. One of the most common errors into which the tyro can fall is to assume that expenses and losses are deductible unless explicitly denied, just as all income is caught up by §61 unless excluded by statute or Constitution. If you sell your home at a loss, you will look in vain for a statute forbidding you — at least in terms more specific than §262 — to deduct the loss. The loss is nevertheless non-deductible, because a deduction is not specifically authorized. This is an illustration of the old stereotype of the German attitude toward liberty: whatever is not permitted by law is forbidden.

Even when a deduction is found in the Code, the taxpayer will often be confronted by the adage that deductions are to be strictly construed against him. Why? Would it be more appropriate to apply the canon of construction advocated by Mr. Justice Holmes (on circuit) in Johnson v. United States, 163 Fed. 30, 32 (1st Cir. 1908):

> The Legislature has the power to decide what the policy of the law shall be, and if it has intimated its will, however indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before.

See Griswold, An Argument Against the Doctrine that Deductions Should Be Narrowly Construed as a Matter of Legislative Grace, 56 Harv. L. Rev. 1142 (1943).

For purposes of pedagogical convenience, the deductions allowed by the Code have been divided into two groups:

(1) *Personal deductions.* These deductions (including such items as medical expenses, alimony, interest, certain taxes, and others) are taken up in the pages that immediately follow this Note. This group is characterized by the fact that the taxpayer need not be engaged either in business or in a profit-making transaction to qualify for the deduction.

Another point of importance about this first group of deductions is that the taxpayer is granted an option with respect to them. He can either itemize them on the tax return or elect instead to take the "standard deduction" provided by §§141-144. (Election of the standard deduction also entails a waiver of certain credits. See §36.) This optional deduction is 10 per cent of the taxpayer's "adjusted gross income" (roughly speaking, gross income less most business and similar expenses; see p. 328 infra) but not to exceed $1000 or, in the unusual case of a married person filing a separate return, $500. (Under a 1964 amendment, moreover, the standard deduction is not less than $300, plus $100 for each exemption over one.) Thus, if the taxpayer's personal deductions are small, or if he does not wish to trouble himself with an itemization, he may elect the standard deduction. The standard deduction was adopted in 1944 as a means of simplifying the tax return; it does that, and for many taxpayers who are convinced that to itemize will be profitless it does away with the need to keep a record of these personal expenses. There is some risk in such a calculus, however, since one cannot be sure until the end of the year how great one's personal deductions will be. If the Christmas tree starts a fire, giving rise to a deduction for the property loss, a tax-

payer who had planned to take the standard deduction may find out — too late to substantiate personal expenses paid in earlier months — that an itemization would be more advantageous.

The standard deduction was used in 1960 on about 60 per cent of the individual tax returns filed (37 million returns out of 61 million); the remaining 40 per cent itemized the personal deductions, as against only 28 per cent who itemized their deductions in 1954 and 18 per cent in 1944 when the standard deduction was first made generally available. The use of the standard deduction is especially common on the smaller returns; since it cannot exceed $1000, its use declines as income rises. Thus the standard deduction was used in 1960 on 62 per cent of the returns with adjusted gross income of $3000-$5000, on 30 per cent of those with adjusted gross income of $10,000-$20,000, on 12 per cent of those with adjusted gross income of $20,000-$50,000, and on only 3 per cent of those with adjusted gross income of over $50,000.

It should be noted that the availability of the standard deduction depreciates the value of the personal deductions. Before it was adopted, the taxpayer who made charitable contributions or paid interest on a mortgage or real property taxes on his home received a tax concession that another taxpayer with equal income who made no contributions and rented a home did not get. Now, however, the two taxpayers will be on a par if the former one does not have personal deductions exceeding the standard deduction; and even if his deductions do exceed the standard deduction, the disparity between them is not as great as it was. To the extent that the personal deductions are a conscious instrument of policy, designed to encourage home ownership or philanthropy, their effect is less pronounced than before the standard deduction was created.

Finally — and perhaps most important — it should be noted that these personal deductions constitute exceptions to the general rule of §262 that "no deduction shall be allowed for personal, living, or family expenses." In studying these exceptions, the student should ask himself why these particular "personal, living, or family expenses" should be singled out for deductibility. See Pechman, Erosion of the Individual Income, 10 Nat. Tax J. 1, 6 et seq. (1957); articles by various authors in 1959 Tax Revision Compendium (House Committee on Ways and Means) 365-472; Kahn, Personal Deductions in the Federal Income Tax (1960).

(2) *Business deductions.* These deductions, which are taken up in Chapter 3, arise in the course of the taxpayer's "trade or business" (a phrase that includes professions and other occupations) or in a transaction entered into for profit. Roughly speaking, the taxpayer is allowed to deduct all ordinary expenses and losses that grow out of his business and his transactions for profit. The standard deduction mentioned above may be elected in addition to the taxpayer's business deductions (with some minor exceptions to be noted infra p. 328). As already seen, election of the standard deduction displaces all personal deductions.

1. *Extraordinary Medical Expenses*

Section 213, allowing a deduction for extraordinary medical expenses, was carried over, with a number of modifications in detail, from §23(x) of the 1939 Code.

OCHS v. COMMISSIONER
195 F.2d 692 (2d Cir. 1952)

Before Augustus N. Hand, Chase and Frank, Circuit Judges.

A. N. Hand, Circuit Judge.

The question raised by this appeal is whether the taxpayer, Samuel Ochs, was entitled under [§213] to deduct the sum of $1,456.50 paid by him for maintaining his two minor children in day school and boarding school as medical expenses incurred for the benefit of his wife. . . .

The Tax Court made the following findings:

"During the taxable year petitioner was the husband of Helen H. Ochs. They had two children, Josephine age six and Jeanne age four.

"On December 10, 1943, a thyroidectomy was performed on petitioner's wife. A histological examination disclosed a papillary carcinoma of the thyroid with multiple lymph node metastases, according to the surgeon's report. During the taxable year the petitioner maintained his two children in day school during the first half of the year and in boarding school during the latter half of the year at a cost of $1,456.50. Petitioner deducted this sum from his income for the year 1946 as a medical expense under [§213].

"During the taxable year, as a result of the operation on December 10, 1943, petitioner's wife was unable to speak above a whisper. Efforts of petitioner's wife to speak were painful, required much of her strength, and left her in a highly nervous state. Petitioner was advised by the operating surgeon that his wife suffered from cancer of the throat, a condition which was fatal in many cases. He advised extensive X-ray treatment after the operation. Petitioner became alarmed when, by 1946, his wife's voice had failed to improve, and believed that the irritation and nervousness caused by attempting to care for the children at a time when she could scarcely speak above a whisper might cause a recurrence of the cancer. Petitioner and his wife consulted a reputable physician and were advised by him that if the children were not separated from petitioner's wife she would not improve and her nervousness and irritation might cause a recurrence of the cancer. Petitioner continued to maintain his children in boarding school after the taxable year here involved until up to the end of five years following the operation of December 10, 1943, petitioner having been advised that if there was no recurrence of the cancer during that time his wife could be considered as having recovered from the cancer.

"During the taxable year petitioner's income was between $5,000 and $6,000. Petitioner's two children have not attended private school but have lived at home and attended public school since a period beginning five years after the operation of December 10, 1943. Petitioner's purpose in sending the children to boarding school during the year 1946 was to alleviate his wife's pain and suffering in caring for the children by reason of her inability to speak above a whisper and to prevent a recurrence of the cancer which was responsible for the condition of her voice. He also thought it would be good for the children to be away from their mother as much as possible while she was unable to speak to them above a whisper.

"Petitioner's wife was employed part of her time in 1946 as a typist and stenographer. On account of the impairment which existed in her voice she found it difficult to hold a position and was only able to do part-time work. At the time of the hearing of this proceeding in 1951, she had recovered the use of her voice and seems to have entirely recovered from her throat cancer."

The Tax Court said in its opinion that it had no reason to doubt the good faith and truthfulness of the taxpayer and that his devotion and consideration for his wife were altogether admirable, but it nevertheless held that the expense of sending the children to school was not deductible as a medical expense under the provisions of [§213].

In our opinion the expenses incurred by the taxpayer were non-deductible family expenses within the meaning of [§262] rather than medical expenses. Concededly the line between the two is a difficult one to draw, but this only reflects

the fact that expenditures made on behalf of some members of a family unit frequently benefit others in the family as well. The wife in this case had in the past contributed the services — caring for the children — for which the husband was required to pay because, owing to her illness, she could no longer care for them. If, for example, the husband had employed a governess for the children, or a cook, the wages he would have paid would not be deductible. Or, if the wife had died, and the children were sent to a boarding school, there would certainly be no basis for contending that such expenses were deductible. The examples given serve to illustrate that the expenses here were made necessary by the loss of the wife's services, and that the only reason for allowing them as a deduction is that the wife also received a benefit. We think it unlikely that Congress intended to transform family expenses into medical expenses for this reason. The decision of the Tax Court is further supported by its conclusion that the expenditures were to some extent at least incurred while the wife was acting as a typist in order to earn money for the family. We do not think that the decisions discussed in the opinion of the Tax Court and the briefs of the parties have any real bearing upon the issues involved in this appeal.

The decision is affirmed.

FRANK, Circuit Judge (dissenting).

Humane considerations in revenue laws are undeniably exceptional. But there is no good reason why, when, for once, Congress, although seeking revenue, shows it has a heart, the courts should try to make it beat feebly. Here is a man earning between $5,000 and $6,000 a year. His wife was operated on for cancer three years earlier and has still not regained the use of her voice. The doctor says that she will not get any better — may indeed have a recurrence of the cancer, this time surely fatal — unless she is separated from her two children, aged six and four. The children are young, healthy, active and irrepressible; their mother cannot speak above a whisper without pain. She becomes ever more nervous and irritable when they are around; her voice does not improve when it should. The father (instead of sending her to a sanitarium) sends the children away to school and seeks to deduct the cost therefor as a "medical expense."

The Commissioner, the Tax Court, and now my colleagues, are certain Congress did not intend relief for a man in this grave plight. The truth is, of course, no one knows what Congress would have said if it had been faced with these facts. The few paltry sentences of Congressional history for [§213] do not lend strong support — indeed any support at all — to a strict construction theory:

> This allowance is granted in consideration of the heavy tax burden that must be borne by industry during the existing emergency [1942] and of the desirability of maintaining the present high level of public health and morale. . . . The term "medical care" is broadly defined to include amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body. It is not intended, however, that a deduction should be allowed for any expense that is not incurred primarily for the prevention or alleviation of a physical or mental defect or illness.[1]

I think that Congress would have said that this man's expense fell within the category of "mitigation, treatment, or prevention of disease," and that it was for the "purpose of affecting [a] structure or function of the body." The Commissioner argued, successfully in the Tax Court, that, because the money spent was only indirectly for the sake of the wife's health and directly for the children's maintenance, it could not qualify as a "medical expense." Much is made of the fact that the children themselves were healthy and normal — and little of the

[1] Sen. Rep. 1631, 77th Cong., 2d Sess. (1942) 95-96.

fact that it was their very health and normality which were draining away the mother's strength. The Commissioner seemingly admits that the deduction might be a medical expense if the wife were sent away from her children to a sanitarium for rest and quiet, but asserts that it never can be if, for the very same purpose, the children are sent away from the mother — even if a boarding-school for the children is cheaper than a sanitarium for the wife. I cannot believe that Congress intended such a meaningless distinction, that it meant to rule out all kinds of therapeutic treatment applied indirectly rather than directly — even though the indirect treatment be "primarily for the . . . alleviation of a physical or mental defect or illness." [2] The cure ought to be the doctor's business, not the Commissioner's.

The only sensible criterion of a "medical expense" — and I think this criterion satisfies Congressional caution without destroying what little humanity remains in the Internal Revenue Code — should be that the taxpayer, in incurring the expense, was guided by a physician's bona fide advice that such a treatment was necessary to the patient's recovery from, or prevention of, a specific ailment.

Indeed, a test for [§213's] applicability, much akin to the one I have in mind, was adopted by the Tax Court in Havey v. Commissioner, 12 T.C. 409, 412:

> In determining allowability, many factors must be considered. Consideration should be accorded the motive or purpose of the taxpayer, but such factor is not alone determinative. To accord it conclusive weight would make nugatory the prohibition against allowing personal, living, or family expenses. Thus also it is important to inquire as to the origin of the expense. Was it incurred at the direction or suggestion of a physician; did the treatment bear directly on the physical condition in question; did the treatment bear such a direct or proximate therapeutic relation to the bodily condition as to justify a reasonable belief the same would be efficacious; was the treatment in proximate time so near to the onset or recurrence of the disease or condition as to make one the true occasion of the other, thus eliminating expense incurred for general, as contrasted with some specific physical improvement.

This taxpayer can, I think, meet every requirement of the *Havey* test. (1) *Motive:* Ochs could have no motive but his wife's health in sending the children away. They had never attended before — nor have they attended since — private schools. A man earning less than $6,000 with three dependents would not normally send his children to boarding-school. The four-year-old would most likely have stayed home; the six-year-old, if she went to school at all, would have gone to a free public school. Day school and boarding-school were indispensable only because they filled up the children's play and leisure hours — when they would have harassed their mother. The Commissioner doesn't argue that Ochs chose a more expensive school than he had to; nor even that the wife might have been more economically sent away from home. He does suggest, however, that, since the change benefitted the children as well as the mother, it cannot be considered a medical expense because not incurred solely for the mother's recovery. Con-

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2 The Commissioner has, in the past, shown more liberal tendencies in sanctioning somewhat unorthodox kinds of treatment as contemplated by the statute: He has allowed the deduction of fees paid to chiropractors and Christian Science practitioners. I.T. 3598, 1943 C.B. 157. He should not, in this context, lag behind the progress of the medical art. Especially in this case should the Commissioner realize the growing emphasis placed by medical practitioners upon peace of mind as a major factor in the recovery of patients from what were formerly thought to be entirely organic diseases. If the wife here had been recovering from a nervous breakdown, it could not be sensibly argued that the cure did not fit the disease. Are we ready now to discount the uncontroverted evidence of the doctor in this case that peace of mind and body (it takes not only mental but physical gymnastics to keep up with two children aged four and six) was essential to recovery from, and prevention of, a throat cancer?

[See Ring v. Commissioner, 23 T.C. 950 (1955) (disallowing cost of trip to shrine at Lourdes).]

gress required only that medical expenses be "primarily" for the patient's recovery. The evidence here, moreover, establishes (and the Tax Court so found) that the effect on the wife's health was the sole consideration inducing her husband's action even if it was not the sole result. (2) *Doctor's advice:* Ochs' action was precipitated by the strong warning of a physician. The doctor predicted that the wife might not recover if the children stayed at home. (3) *Relation between illness and treatment:* The physician advised sending the children away because their presence required vocal exertion on the mother's part — strain and pain in the vulnerable throat region. The advice was aimed to aid the mother's specific throat condition and not just her general well-being or disposition. The physician's warning was certainly ominous enough to instill in the taxpayer a "reasonable belief that the 'treatment' would be efficacious." (4) *Proximity in time of treatment to illness:* The children were sent away as soon as possible after the doctor's advice. They were kept in schools until the five-year danger period of cancer recurrence was over. Then they were brought home, and have never been to private schools since. It is true that the children were kept at home for three years after the cancer operation. But the doctor who counseled their separation was not consulted until 1946, when Mrs. Ochs' lack of improvement became very noticeable.

In the final analysis, the Commissioner, the Tax Court and my colleagues all seem to reject Mr. Ochs' plea because of the nightmarish spectacle of opening the floodgates to cases involving expense for cooks, governesses, baby-sitters, nourishing food, clothing, frigidaires, electric dish-washers — in short, allowances as medical expenses for everything "helpful to a convalescent housewife or to one who is nervous or weak from past illness." I, for one, trust the Commissioner to make short shrift of most such claims. The tests should be: Would the taxpayer, considering his income and his living standard, normally spend money in this way regardless of illness? Has he enjoyed such luxuries or services in the past? Did a competent physician prescribe this specific expense as an indispensable part of the treatment? Has the taxpayer followed the physician's advice in the most economical way possible? Are the so-called medical expenses over and above what the patient would have to pay anyway for his living expenses, i.e., room, board, etc.? Is the treatment closely geared to a particular condition and not just to the patient's general good health or well-being?

My colleagues are particularly worried about family expenses, traditionally non-deductible, passing as medical expenses. They would classify the children's schooling here as a family expense, because, they say, it resulted from the loss of the wife's services. I think they are mistaken. The Tax Court specifically found that the children were sent away so they would not bother the wife, and not because there was no one to take care of them. Ochs' expenditures fit into the Congressional test for medical deductions because he was compelled to go to the expense of putting the children away primarily for the benefit of his sick wife. Expenses incurred solely because of the loss of the patient's services and not as a part of his cure are a different thing altogether. Wendell v. Commissioner, 12 T.C. 161, for instance, disallowed a deduction for the salary of a nurse engaged in caring for a healthy infant whose mother had died in childbirth. The case turned on the simple fact that, where there is no patient, there can be no deduction.

Thus, even here, expense attributed solely to the education, at least of the older child, should not be included as a medical expense. See Stringham v. Commissioner [12 T.C. 580, aff'd per curiam, 183 F.2d 579 (6th Cir. 1950)]. Nor should care of the children during that part of the day when the mother would be away, during the period while she was working part-time. Smith v. Commissioner, 40

B.T.A. 1038, affirmed 2 Cir., 113 F.2d 114. The same goes for any period when the older child would be away at public school during the day. In so far as the costs of this private schooling are thus allocable, I would limit the deductible expense to the care of the children at the times when they would otherwise be around the mother. If my views prevailed, this might require a remand to the Tax Court for such allocation.

Line-drawing may be difficult here as everywhere, but that is what courts are for. See Lavery v. Purssell, 399 Ch. D. 508, 517: ". . . courts of justice ought not to be puzzled by such old scholastic questions as to where a horse's tail begins and where it ceases. You are obliged to say, this is a horse's tail at some time."

NOTE

1. *Other borderline expenses.* If the taxpayer spends the winter in Florida for the general improvement of his health, the Regulations deny any deduction; there must be a closer connection between the climate and his health (e.g., alleviation of a specific chronic ailment) to support a deduction. See Regs. §1.213-1(e)(1)(iv); Dobkin v. Commissioner, 15 T.C. 886 (1950). Before 1954, a taxpayer who could establish a sufficiently persuasive need for a trip to another part of the country could deduct not only the cost of transportation, but also his meals and lodging. But the enactment in 1954 of §213(e)(1)(B), defining the term "medical care" to include the cost of necessary transportation, excluded by implication the cost of meals and lodging. Commissioner v. Bilder, 369 U.S. 499 (1962). If the taxpayer is in a hospital, however, the cost of his meals and lodging is deductible; the deductibility of meals and lodging in other types of institutions (e.g., nursing homes) depends upon whether the taxpayer is institutionalized primarily for medical care. See Regs. §1.213-1(e)(1)(v); Lichterman v. Commissioner, 37 T.C. 586 (1961).

Regs. §1.213-1(e)(1)(iii) provides that "a capital expenditure for a permanent improvement or betterment of property shall not be deductible as an expenditure for medical care, even though it may have some relation to medical case," citing swimming pools, additions to the first floor of a house, and home elevators as examples of non-deductible items. The cases are reviewed in Riach v. Frank, 302 F.2d 374 (9th Cir. 1962), involving the cost of "Hil-A-Vator" installed to transport the taxpayer, suffering from a cardiac condition, up and down a steep hillside on which his home was constructed, in which the taxpayer was allowed to deduct the difference between the cost of the device and the increase in the value of his home attributable to its installation.

For other borderline items, see Regs. §1.213-1(e)(1); Rev. Rul. 55-261, 1955-1 C.B. 307 (treatment of cost of remedial reading programs, health institutes, air-conditioning equipment, specially equipped automobiles, maternity clothing, wigs, special foods and beverages, etc.); Rev. Ruls. 58-8 and 58-280, 1958-1 C.B. 154 and 157.

2. *Medicine and drugs.* In 1954, §213(b) was enacted to permit the cost of medicine and drugs to be "taken into account" only to the extent that they exceed 1 per cent of adjusted gross income. The Senate Report (p. 219) states:

> While some question has been raised under present law by taxpayers as to whether the expenditures for toiletries and sundry items may be taken into account this provision makes it clear that expenditures for medicine and drugs (whether or not requiring a prescription) are taken into account but expenditures for toiletries and sundries are not.

See Regs. §1.213-1(e)(2), allowing drugs to be deducted only if "legally procured" and excluding entirely toothpaste, shaving lotions, face creams, deodorants, etc. See also Regs. §1.213-1(e)(1)(ii), disallowing amounts paid for illegal operations or treatments.

In 1964, the 1 per cent limit on drugs and medicine was eliminated for certain expenses attributable to the taxpayer and his wife, if either is 65 or older, or to a dependent parent who is 65 or older.

3. *Limitations on the deduction.* When the medical expense deduction was first enacted, it was intended to relieve the taxpayer whose medical expenses (for himself, his

spouse, and his dependents) were "extraordinary" in amount — a deduction was permitted only if, and to the extent that, the expenses for the taxable year exceeded 5 per cent of the taxpayer's "adjusted gross income." (For the meaning of this term, see p. 329 infra.) In 1954, the non-deductible limit was lowered from 5 per cent to 3 per cent, and it was abolished for expenses incurred for the care of the taxpayer or his spouse if either is over 65. By a later amendment, the limit was also made inapplicable to expenses incurred for the care of a dependent parent over the age of 65.

Although the expenses must be "extraordinary" (at least ordinarily!), they must not be too extraordinary: the deduction may not exceed certain maximum amounts that vary from $5000 (single taxpayer without dependent) to $40,000 (joint return, if both taxpayers are over 65 and disabled). The various limits have become so intricate with successive amendments to §213 that the Internal Revenue Service has published a special form (Form 2948) to assist in the computation.

Despite their intricacies, the limits can be avoided to a certain extent by postponing payments, since §213(a) speaks of expenses "paid during the taxable year." This possibility is illustrated by a story from the New Yorker (April 4, 1953, p. 26):

> During the third week of December, a baby girl was delivered at the New York Hospital — everything O.K. The father had a chat with the officiating obstetrician and emerged from his office looking annoyed. He visited his wife and child daily during the prescribed week of confinement, but then, instead of picking them up the next day, he failed to show. The interne asked the obstetrician if there were any complications; he said no. A couple more days passed, and no husband. The wife, pressed by the staff for an explanation, looked glum, smoked, and offered none. Finally, on New Year's Day — five days after his family should have been home — he appeared, beaming, settled the hospital bill, and whisked his wife and child to the elevator. The nurse who was holding the baby ventured to ask him what was going on. "Young woman," he said, "I was told when the baby was born that the obstetrician's bill couldn't possibly be made up and presented for payment until sometime in January. I was damned if I'd split the medical deductions on my income tax between two years, so I waited until 1953 to take care of the hospital charges." And off he and his little family went, into a deductible taxi. [Reprinted by permission. Copyrighted 1953, The New Yorker Magazine, Inc.]

A prepayment of a hospital bill, however, was held to be non-deductible in Bassett v. Commissioner, 26 T.C. 619 (1956), on the ground that it was not a payment of an "expense" since the care had not yet been rendered and no duty to pay had arisen.

4. *Effect of reimbursement of medical expenses.* Note that expenses may be deducted only if "not compensated for by insurance or otherwise."

Although §104 (supra p. 154) provides for the exclusion from income of amounts received as compensation for personal injuries or sickness, note that it is inapplicable "in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 . . . for any prior taxable year." This prevents a doubling up of tax benefits.

Section 105 (exempting certain amounts received under employee accident and health plans) also contains cross references to §213. Amounts received by the employee under §105(c) (payments for permanent injury) or under §105(d) (compensation during sick leave) are not to be treated as compensation for medical expenses; the employee may exclude these amounts and also may deduct his medical expenses under §213. Where the employee is reimbursed for his medical expenses, however, §§105(a) and 105(b) operate to prevent double deductions: if the expenses were previously deducted, the reimbursement is includible in gross income; otherwise, the reimbursement is excluded from gross income, but the expenses cannot be deducted because they have been "compensated for by insurance or otherwise."

5. *Medical expenditures as business expenses.* On rare occasions, medical expenses have been held deductible under §162 as "ordinary and necessary expenses" of carrying on the taxpayer's occupation. Thus, Reginald Denny was allowed to deduct the cost of replacing teeth knocked out in the course of making a prize fight movie, Denny v. Commissioner, 33 B.T.A. 738 (1935). But Madge Evans' tonsillectomy was held not a deductible business expense. Evans v. Commissioner, 1939 B.T.A. ¶39,101 P-H Memo. Here

the court said: "The operation was performed for the purpose of correcting petitioner's susceptibility to colds. There has been no showing that these colds resulted from petitioner's business activities." No doubt many individuals could prove that various ailments resulted from their occupation. Would the expenses then be deductible? What of a lawyer's hypertension? To the extent that medical expenses are deductible as business expenses under §162, they are not subject to the 3 per cent and dollar limitations of §213 and may be deducted in addition to the optional "standard deduction" (infra p. 328). See Rev. Rul. 57-461, 1957-2 C.B. 116, ruling that the expense of maintaining a "seeing-eye" dog used daily in the conduct of the taxpayer's business can be deducted only as a medical expense under §213 and not as a business expense under §162.

6. *References.* Fisher, What Constitutes a Medical Deduction; Medical Dependency; Sick Pay, 21 N.Y.U. Inst. on Fed. Taxation 169 (1963); Jensen, Medical Expenditures and Medical Deduction Plans, 60 J. Pol. Econ. 503 (1952); Jensen, Rationale of the Medical Expense Deduction, 7 Nat. Tax J. 274 (1954).

2. *Charitable Contributions*

Section 170 is a consolidation, with some modifications, of §23(o), §120, and §23(q) of the 1939 Code.

HAVEMEYER v. COMMISSIONER

98 F.2d 706 (2d Cir. 1938)

Before L. Hand, Swan, and Chase, Circuit Judges.

Chase, Circuit Judge. . . .

The question presented is whether the petitioner was entitled, under the provisions of [§170], to a deduction for contributions he made in that year to an unincorporated association known as the United Special Aid Association. The Commissioner decided that he was not entitled to the deduction and determined the deficiency by adding the amount claimed to his gross income. The Board of Tax Appeals upheld the action of the Commissioner.

The United Special Aid Association was formed in 1918 by the petitioner, members of his family, and a close business associate. It was organized in compliance with the law regulating the formation of unincorporated associations and, to quote from its articles of association, "in order to unify and co-ordinate the charitable activities of themselves and other persons who may hereafter become members of this Association" and "to be operated exclusively for charitable purposes." Its members comprised the original signers of the articles of association to whom might be added such other persons as might be elected by a majority vote of the Board of Managers. A member was bound to pay annual dues of five dollars and was otherwise free to contribute or not as desired. The Board of Managers consisted of five persons to be elected at each annual meeting of the Association since its formation. Under a provision making three a quorum of the Board of Managers, the petitioner and two others have been in actual charge of its affairs. From the time it was formed and up to the year 1932, the Association had received $47,975.87 and had distributed the sum of $46,992.23. In 1932 it had nine members who contributed $3,618.85 of which the petitioner gave $2,257.60. That is the deduction he claimed which was disallowed. During 1932, the Association assisted nine indigent and deserving individuals. None of them were related to any of the members by blood or marriage and no member was under any legal or equitable obligation to contribute to the support of any of the beneficiaries who, though it was customary for a contributor to suggest the person to be aided, were all designated by the Board of Managers. They

were mainly, though not entirely, old family retainers and all were needy and worthy.

The constitution of the Association provided in part that:

> The purpose of this Association shall be to collect funds and therefrom to give relief to such indigent and deserving persons as the Board of Managers may from time to time consider to be in especial need of the bounty of the Association. No payment shall be made from the funds of the Association to or for the use of any officer, manager, or member of the Association.

The provisions of the constitution have at all times been carried out in good faith and the books and records of the Association have always been kept without expense to it. The meetings of its Board of Managers have been held in the offices of Havemeyer & Elder, Inc., which is a corporation of which the members of the board who have been in active charge are officers. . . .

No claim is made that the contribution made by the petitioner to the Association exceeded the proportion of his income deductible under [§170(b)] if made to a charitable organization therein designated but the theory on which the deduction was disallowed and its disallowance upheld by the Board was that this Association served but as a means for facilitating the bestowal of private bounties and could not be classed as a charitable association within the meaning of [§170 (c)(2)].

It is true that the beneficiaries who were actually designated by the Board of Managers were all personally known to one or more members of the Association and were people who might perhaps have been given aid by one or more of them had the Association not been in existence but that does not change the character of the Association itself. That was as extensive in charitable scope within the ranks of the indigent and deserving public as its means and the discretion of its Board of Managers might make it. Its activities were exclusively charitable within the statutory meaning of that term. Harrison v. Barker Annuity Fund, 7 Cir., 90 F.2d 286, 289; Gimbel v. Commissioner, 3 Cir., 54 F.2d 780; Bok v. McCaughn, 3 Cir., 42 F.2d 616. And they were all of the kind it was organized to conduct as shown by the articles of association and within the limitations of its constitution. Having been organized to perform exclusively acts of charity and having performed such acts and no others, this Association in form and fact was a charitable association of the kind named in [§170(c)(2)]. It had no net earnings so far as appears and certainly no part of them, if it had any, inured to the benefit of any private shareholder or individual having a personal and private interest in the activities of the Association. . . . Consequently gifts made by individuals to the Association within the taxable year were deductible in computing the net income of the petitioner.

Reversed.

L. HAND, Circuit Judge (dissenting).

It seems to me that this was not the kind of charitable association that the statute had in mind. Practically, it was a pool of the charitable contributions of the Havemeyer family, distributed by two of them — the petitioner being one — helped by a business associate. True, it does not expressly appear that any member of the family could insist upon his contributions going to an especial person, and in law no doubt he could not; but I cannot believe that practically this was not the case. I am not altogether clear that a taxpayer might deduct a contribution even to a standard charitable association, if in advance he were to exact an agreement that it should be devoted to a particular person. If the association asks him for special funds, of course, he may; but I am speaking of a case where

he uses it merely as a conduit. However that may be, it was an inference which the Board might make that here this association was nothing else but a conduit. While the family was to manage the pot through three managers, of whom the petitioner was only one, I cannot take seriously the possibility that, at least as to his own contributions, his two associates would have attempted to gainsay any distribution he wished. It is significant for example that his and his wife's distributions for 1932 just used up his contributions. As to him anyway and to the extent of the deductions now claimed, I think this association was pro hac vice merely a conduit. In general I believe that we ought not to countenance avoidance of taxes by the perpetual device of a corporation, organized only in form, and not in reality, for the purposes intended by a statute.

NOTE

1. *Aid to deserving individuals vs. contributions to charities.* Why does the Code require that a contribution, to be deductible, go to a charitable organization rather than to a needy or deserving individual? With the *Havemeyer* case, see Waller v. Commissioner, 39 T.C. 665 (1963) (organization qualifies although trustees were directed to give preference in their benefactions to donors' relatives, former employees, and children of employees); DeJong v. Commissioner, 309 F.2d 373 (9th Cir. 1962) (portion of contribution to tax-exempt educational institution treated as payment of tuition for donor's children; no regular tuition charge was established, but parents were advised of school's financial requirements and asked to contribute to the best of their ability); Tripp v. Commissioner, ¶63,244 P-H Memo T.C. (contribution to college in expectation that it would be credited to the account of a student designated by donor, initiative having come from donor rather than college; held, not deductible); Rev. Rul. 58-303, 1958-1 C.B. 61 (payment to home for aged where taxpayer's father lived; no deduction).

Does Judge L. Hand's dissenting opinion in *Havemeyer* imply that a deduction should not be allowed if a gift is made on condition that it be used for a purpose designated, or originated, by the donor: e.g., the construction of a building to house a collection of Old Icelandic literature, or to be named after the donor's favorite aunt?

Section 170(d), enacted in 1960, permits the taxpayer to deduct the cost of maintaining a grade school student in his home under certain institutional programs to provide educational opportunities, especially for foreign students. The maximum deduction is $600 per student per year.

2. *Scope of term "charitable contribution."* While the term "charitable contribution" is commonly used and, indeed, is sanctioned by §170(a) itself, it is defined by §170(c) to embrace contributions for public, religious, scientific, literary, educational, and humane, as well as charitable, purposes and to include certain gifts to organizations of war veterans, fraternal societies, and cemetery companies. Note, however, the qualification of §170(c)(2), permitting certain contributions to be deducted *by a corporation* only if they are to be used within the United States or its possessions. As to individuals, §170(c)(2)(A) requires the organization to be "created or organized in the United States," etc., but no geographical restriction is imposed on the use of the contribution. See Rev. Rul. 63-252, 1963-2 C.B. 101.

Does the inclusion of religious organizations in the qualified categories raise any First Amendment problems? Must contributions to agnostic and atheist societies be accorded the same treatment as contributions to religious groups?

3. *Restrictions on the donee organization's activities.* Section 170(c)(2) (religious, charitable, scientific, literary, educational, and humane organizations), §170(c)(3) (organizations of war veterans), and §170(c)(5) (cemetery companies) state expressly that no part of the net earnings of the organization may inure to the benefit of private shareholders or individuals; and this restriction is implicit in §170(c)(1) ("exclusively public purposes") and in §170(c)(4). Do the net earnings of an otherwise qualified organization inure "to the benefit of any private shareholder or individual" if its capital or income is used to pay the creator of the organization (a) wages, (b) indebtedness incurred in acquiring the assets, or (c) an annuity or other charge to which the assets were subject

when conveyed to the organization? See Commissioner v. Orton, 173 F.2d 483 (6th Cir. 1949); Mabee Petroleum Corp. v. United States, 203 F.2d 872 (5th Cir. 1953); W. L. Powell Foundation v. Commissioner, 222 F.2d 68 (7th Cir. 1955); Boman v. Commissioner, 240 F.2d 767 (8th Cir. 1957).

These prohibitions on private benefit are buttressed by §503, enacted in 1950, which disqualifies certain charitable organizations if they engage in a "prohibited transaction" (roughly speaking, a non-arm's-length transaction with a substantial contributor or other related person). Some of these transactions might violate the more general language of §170, but §503 arms the Internal Revenue Service with a more explicit statutory weapon. Section 504 goes on to disqualify such organizations if they unreasonably accumulate income, use income for non-exempt purposes, or invest income so as to jeopardize their tax-exempt function. The cases in this area are reviewed in Erie Endowment v. United States, 316 F.2d 151 (3d Cir. 1963). Both §503 and §504 are designed primarily to regulate "private" charitable foundations that, by reason of their continuing relations with their grantors, may serve private interests more effectively than the public interest.

Section 170(c)(2) also disqualifies the recipient of a contribution if a "substantial part" of its activities is "carrying on propaganda, or otherwise attempting, to influence legislation." Seasongood v. Commissioner, 227 F.2d 907 (6th Cir. 1955); Dulles v. Johnson, 273 F.2d 362 (2d Cir. 1959). Section 11 of the Internal Security Act of 1950 similarly disqualifies "communist-action" organizations, a policy which the Treasury Department had previously followed as to organizations on the Attorney General's list of subversive organizations. Treasury Department, Press Service, Release No. S-613, Feb. 4, 1948. Cf. Joint Anti-Fascist Refugee Committee v. McGrath, 341 U.S. 123 (1951).

4. *Contributions of services and facilities.* Because §170(a)(1) requires "payment" of the contribution, the Internal Revenue Service takes the position that the gift must consist of money or other "property," and has ruled that a deduction cannot be taken for the rental value of property that a charity is allowed to occupy. I.T. 3918, 1948-2 C.B. 33; but see Passailaigue v. United States, 224 F. Supp. 682 (M.D. Ga. 1963) (rental value of property occupied by charity under lease for indefinite period, terminable by taxpayer on 15 days' notice, held deductible). See also Rev. Rul. 162, 1953-2 C.B. 127 (taxpayer contributed blood to a charity; held, non-deductible because "analogous to the rendering of a personal service by the donor rather than a contribution of 'property' "). A related issue is the performance of services under an arrangement by which the charity receives a fee or makes a profit. See G.C.M. 27026, infra page 344.

Since a contribution "for the use of," as well as "to," a charitable organization is permissible by virtue of §170(c), however, the Internal Revenue Service acknowledges that a taxpayer who incurs out-of-pocket unreimbursed expenses in rendering services to a charity (e.g., transportation expenses) may deduct them. Regs. §1.170-2(a)(2); see also Orr v. United States, 226 F. Supp. 809 (M.D. Ala. 1963) (layman active in church affairs; held, out-of-pocket expenses do not include prorated depreciation, insurance, or repairs on his automobile and airplane).

5. *Percentage limits on charitable contributions.* For many years, an individual taxpayer could not deduct more than 15 per cent of his "adjusted gross income" (infra p. 329) for charitable contributions. In 1952, this ceiling was raised to 20 per cent. Since 1954, an additional 10 per cent allowance, bringing the aggregate up to 30 per cent, has been available for contributions to a specially favored group of charitable donees; the list of "30 per cent charities" originally included only churches, schools and colleges, and hospitals, but it has been expanded to include any charitable organization that normally receives a substantial part of its support from the general public (as distinguished from "private" foundations and similar agencies), medical research organizations, and governmental units. In 1964, in addition to enlarging the list of "30 per cent charities," Congress authorized individuals to carry forward their "excess" contributions to such donees for a 5-year period.

The 30 per cent limit is not applicable if the taxpayer meets the standard of generosity specified by §170(b)(1)(C), which grants an unlimited charitable contribution if the taxpayer's contributions plus his income taxes exceed 90 per cent of his taxable income for 8 out of the 10 preceding years. Section 170(b)(1)(C) is sometimes called the "Philadelphia nun" provision, because it is said to have been enacted for the benefit of a

woman who joined a religious order under an oath of poverty but could not make an assignment of her interest in a family trust that would be effective for tax purposes because of a spendthrift clause. (See I.T. 4035, 1950-2 C.B. 60.) However specialized its origin, §170(b)(1)(C) appears to have attracted more general interest, judging from the esoteric limitations imposed on it in 1964 by the enactment of §170(g).

In the case of corporations, the limit on the deductions is 5 per cent of taxable income (as defined). A corporation whose contributions exceed the 5 per cent limit may carry over the excess and use it as a deduction in the next five years, if its contributions then fall short of the allowable 5 per cent. §170(b)(2).

The impact of the percentage limits can be mitigated by spreading a charitable contribution over a period of years. See, for example, Rev. Rul. 57-293, 1957-2 C.B. 153 (fractional undivided interests in a work of art donated to a museum in successive years); Andrus v. Burnet, 50 F.2d 332 (D.C. Cir. 1931) (sale of property to charity, followed by cancellation of indebtedness in equal amounts each year for a series of years; held, amount forgiven is a charitable contribution in year of forgiveness). A 1964 amendment, however, restricts this practice in the case of tangible personal property (e.g., works of art): if the contribution consists of a future interest, it is to be treated as made only when the intervening rights to possession or enjoyment have expired or are held by someone other than the taxpayer or a person or entity related to him. Thus, a gift of a painting subject to a retained life estate in the taxpayer does not give rise to a current deduction; the contribution is deductible only when his intervening right terminates as a result of his death or is transferred by him to an unrelated person (including the charity itself). The contribution is to be valued as of the time it becomes deductible.

6. *Transfer to charity as a business expense.* Section 162(b) is designed to prevent avoidance of the percentage limits of §170(b) by a claim that the gifts were business expenses. But if the taxpayer is able to show that the payment to the charitable organization was not a "contribution or gift," it may be deducted as a business expense. For an example, see Regs. §1.162-15(b). Presumably moderately selfish motives (such as the desire to improve employee morale or to build goodwill) are not enough; the payment must be motivated by direct business advantages. The prohibition of §162(b) is also inapplicable if the recipient, though having a charitable purpose, does not meet the requirements of §170(b). See B. Manischewitz Co. v. Commissioner, 10 T.C. 1139 (1948); I.T. 3580, 1942-2 C.B. 95. Before 1954, §162(b) was applicable only to corporations; the 1954 Code extended it to individuals as well.

7. *Estate and gift tax deductions for charitable contributions.* In addition to the income tax deduction granted by §170 for charitable contributions, §2522 provides that the donor is not subject to federal gift tax on such contributions and §2055 provides that charitable bequests by a decedent may be deducted in computing the federal estate tax. There are minor variations in the three statutory definitions of qualified donees (e.g., a gift to a cemetery company gives rise to an income tax deduction by virtue of §170(c)(5), but not to a gift or estate tax deduction), but these discrepancies are of minor importance.

8. *Tax exemption of charitable organization itself.* Section 170(c) specifies the organizations that qualify as recipients of deductible contributions; whether these organizations will enjoy immunity from taxation on their investment and other income is not determined by §170(c), however, but by §501. For some organizations, the same characteristics that permit their donors to deduct contributions under §170 also serve to confer tax exemption on the organization itself under §501. Thus, the charitable, religious, and educational organizations that are described by §170(c)(2) will also enjoy tax exemption by virtue of §501(c)(3) — unless the prohibition in §501(c)(3) on intervention in political campaigns is an added requirement, not implicit in §170(c)(2). The overlap is far from complete, however, since posts of war veterans and fraternal lodges may be qualified donees under §170(c) without meeting all of the standards for tax exemption prescribed by §501. Conversely, many organizations that are tax-exempt under §501 (e.g., foreign charities, labor unions, chambers of commerce, etc.) do not meet the requirements of §170(c).

In 1950, the Code was amended (a) to deny tax-exempt status to "feeder organizations" (organizations operated primarily to carry on a trade or business for profit, for

the benefit of a tax-exempt organization), and (b) to tax the "unrelated business income" of many tax-exempt organizations (including rents resulting from certain sales and lease-backs and similar transactions). The 1951 amendments, which appear as §502 and §§511-515 of the 1954 Code, were enacted after a Congressional inquiry in which New York University's acquisition of the Mueller macaroni business and similar ventures into commerce and industry by other universities figured prominently. The fear that tax-exempt organizations would undersell and then buy up or crowd out their competitors was frequently voiced in the hearings. But is it possible that other macaroni makers might *prefer* to compete with a company operated by, or responsible to, trustees whose training and responsibility incline them to caution, rather than with an independent corporation operated in the interest of private stockholders? If the price charged by the Mueller Company for macaroni before its acquisition by New York University was calculated to return it the most profit, would the removal of income tax liability in itself make a lower price more profitable? Underselling aside, does the tax-exempt organization's power to borrow to buy a business, repaying the loan as well as financing expansion out of tax-exempt earnings, constitute a threat to the continuation of private enterprise? Note that investment income (interest, rentals, dividends, etc.) is left untaxed by the 1950 amendments. Is there a danger that universities will drive out competition in this area by cutting interest rates, etc.?

See Sugarman and Pomeroy, Business Income of Exempt Organizations, 46 Va. L. Rev. 424 (1960); Latcham, Private Charitable Foundations: Some Tax and Policy Implications, 98 U. of Pa. L. Rev. 617 (1950); Comment, Colleges, Charities, and the Revenue Act of 1950, 60 Yale L.J. 851 (1951).

REV. RUL. 55-410

1955-1 C.B. 297

Advice has been requested whether the satisfaction of a pledge made in terms of dollars to an organization described in [§170(c)], by the donation or gift of property which has either appreciated or depreciated in value will be considered a taxable event giving rise to a gain or loss for Federal income tax purposes.

[Section 170(a)] allows as a deduction in the case of an individual, subject to prescribed limitations, [charitable contributions] "payment of which is made within the taxable year" to or for the use of certain specified organizations.

[Regulations §1.170-1(a)] provides, in part, that a deduction is allowable [to individuals] only with respect to contributions or gifts which are actually paid during the taxable year, regardless of when pledged and regardless of the method of accounting employed by the taxpayer in keeping his books and records. If the contribution or gift is in a medium other than money, the basis for calculating the amount of the gift is the fair market value of the property at the time of the contribution or gift.

It follows that for purposes of [§170(a)] of the Code the event which gives rise to the deduction is the actual payment of money or the transfer of property. It would be inconsistent to treat such payment or transfer as a "contribution or gift" and at the same time as a satisfaction of a debt with the tax consequences which would ordinarily follow from the use of appreciated property or depreciated to pay a debt.

In view of the foregoing it is held that the satisfaction of a pledge to an organization described in [§170(c)], by means of a donation or gift of property which has either appreciated or depreciated in value, does not give rise to a taxable gain or a deductible loss. Such contribution is deductible to the extent of the fair market value thereof at the time of the contribution or gift. . . .

NOTE

1. *Gifts of "appreciation" alone.* If the taxpayer owns 100 shares of stock which cost him \$25 per share but are worth \$100 per share, which would be the better way to contribute \$7500 to a charitable organization: a gift of 75 shares, or a sale of 100 shares to the charity for \$2500? As an alternative route to the same end, consider a non-recourse loan of \$2500 secured by a pledge of the shares, followed by a gift of the pledged shares (subject to the debt) to the charity. For hazards in this area, see Friedman v. Commissioner, 41 T.C. No. 42 (1963), involving a taxpayer who sold several endowment insurance policies that were about to mature to charitable organizations for amounts equal to his cost for the policies, thus enabling the charities to benefit from the appreciation in value over his cost. The court held that the taxpayer should be treated as though he had collected the proceeds of the policies upon maturity from the insurance company and had thereafter made the gifts, as to three policies that were transferred in the year they matured; but that no income was realized by him in respect of another policy that was transferred the year before its maturity.

2. *Valuation problems.* In Rebay v. Commissioner, ¶63,041 P-H Memo T.C., a non-objective painter deducted \$170,000 over a 5-year period on donating 7 of her paintings to two college art galleries. She had apparently sold only one of her paintings during a long career as an artist; although the price was \$15,000, the sale was made to a business associate of her attorney, who was not an art collector, sought no expert advice before buying, and had never before paid more than \$50 for a painting. After listening to the evidence of experts on market value, and without intending "to reflect any opinion as to the artistic, aesthetic or intrinsic merits of the paintings in issue," the court upheld the Internal Revenue Service in reducing the deduction to \$7000 for 4 of the paintings, and allowed \$2300 for 3 others which the Service had held to lack any market value. It is interesting to reflect on the estate tax problem that would have arisen if the taxpayer had won this income tax case, and then had died with a studio full of unsold paintings.

Since 1962, the individual income tax return has called for information about the cost or other basis, date of acquisition, and method of valuation of property contributed to charities.

3. *Gifts of property held for sale to customers.* A charitable contribution of agricultural, manufactured, or other products held for sale presents a special problem: in addition to claiming a charitable deduction for the fair market value of the property, the taxpayer may seek either to deduct the cost of raising or manufacturing the property as a business expense or to treat the inventory value thereof as part of the cost of goods sold. At one time, the Internal Revenue Service sought to meet this problem by ruling that the fair market value of such property at the time of the contribution was taxable as income, and that it was deductible as a charitable contribution only to the extent of the percentage limitations of §170(b). I.T. 3910, 1948-I C.B. 15. Under this ruling, a contribution would have produced the same tax result as a sale of the property, followed by a donation of the sales proceeds to the charity. See articles by Griswold, Bittker, and Roehner, supra page 103.

After losing several cases in the courts, however, the Service revoked I.T. 3910, but ruled (a) that the taxpayer must make appropriate adjustments (either to inventory or to business expense) to prevent a double deduction and (b) that the charitable deduction is limited to "the replacement cost to the donor in his most favorable market." Rev. Rul. 55-138, 1955-1 C.B. 223. The substance of this ruling is now embodied in Regs. §1.170-1(c)(1), which also provides that the wholesale, rather than the retail, value of the donated property may sometimes be controlling. If a manufacturer's mark-up is high enough, however, the tax reduction attributable to deducting the wholesale value of the goods may exceed their out-of-pocket cost, in which event a "profit" results from the gift. Some of the drug manufacturers who contributed to the Cuban Families Committee for the Liberation of Prisoners of War in 1962 realized such a profit, which in some cases was in turn contributed to charities. See Time, Jan. 4, 1963, p. 1.

Regulations §1.170-1(c)(1) is concerned only with the "double deduction" that may result from deducting both the value of the property (as a charitable contribution) and

the costs and expenses of acquiring or producing it (as business expenses or cost of goods sold). Similar double deduction problems can arise with other types of property (e.g. depreciable property that has given rise to depreciation deductions in prior years, bonds that have been acquired at a premium and amortized, etc.). In some instances, a double deduction is forestalled by a statutory provision, but others are left to the case law. See §170(b)(4) and §170(e); Maysteel Products, Inc. v. Commissioner, 287 F.2d 429 (7th Cir. 1961).

4. *References.* Rudick and Gray, Bounty Twice Blessed: Tax Consequences of Gifts of Property to or in Trust for Charity, 16 Tax L. Rev. 273 (1961); Toll, Tax Problems in Connection with Contributions to Colleges, 1962 So. Calif. Tax Inst. 859; Eaton, Charitable Foundations Making Grants Abroad, 17 Tax L. Rev. 41 (1961); Glassmoyer, Charitable Gifts of Appreciated Property, 20 N.Y.U. Inst. on Fed. Taxation 243 (1962); Lowndes, Tax Advantages of Charitable Gifts, 46 Va. L. Rev. 394 (1960); Neuhoff, How to Make Money by Giving It Away: Tax Consequences of Creating a Charitable Trust, 23 U. of Pitt. L. Rev. 105 (1961); Clark, The Limitation on Political Activities: A Discordant Note in the Law of Charities, 46 Va. L. Rev. 439 (1960); Dickinson (ed.), Philanthropy and Public Policy (1962); articles by various authors in 3 Tax Revision Compendium (House Ways and Means Committee, 1959) 2067-2143.

3. *Alimony*

Section 71 (taxing the wife on certain alimony and separate maintenance payments) and §215 (permitting the husband to deduct his payments if they are taxable to the wife) are based, with some modifications, upon §22(k) and §23(u) of the 1939 Code.

Section 682, relating to alimony trusts, is similarly based, with corresponding changes, on §171 of the 1939 Code.

MAHANA v. UNITED STATES

88 F. Supp. 285 (Ct. Cl. 1950), cert. denied, 339 U.S. 978, rehearing denied, 340 U.S. 847 (1950)

Before JONES, Chief Judge, and MADDEN, HOWELL, WHITAKER and LITTLETON, JJ.

MADDEN, Judge.

The plaintiff sues to recover income taxes paid by her for the years 1943, 1944 and 1945. She filed timely claims for refund which were denied by the Commissioner of Internal Revenue. The money received by her, the taxability of which receipt she contests, came to her, partly directly, and partly through payments by a trustee or depositary, from her husband whom she had divorced.

The plaintiff and George S. Mahana were married in 1893. They separated in 1922. In 1923 she brought an action in New York, where they both resided, for a legal separation and separate maintenance. While this suit was pending, the spouses on November 12, 1923, made a written agreement that the husband would transfer certain named securities to the Guaranty Trust Company of New York, in trust to pay the income to the plaintiff during her lifetime "by way of alimony and in lieu thereof and for her separate maintenance and support." If the income from the securities did not amount to $17,500 per year, the husband would make up the deficit by payments to the trustee for transmission to the plaintiff. If there was an excess of income, it was to be paid to the husband. If the plaintiff's mother survived her, she was to be paid $6,000 per year for life. Upon the death of the survivor of the plaintiff and her mother, the trust was to terminate and the securities were to be returned to the husband. If the securities did not in any one year yield at least $15,000, the husband agreed to add sufficient securi-

ties to bring the yield up to $17,500. The parties mutually released to each other all interest in the other's property and in any rights growing out of their marital relation. The agreement provided that it should in no wise prejudice any right which either party might have to institute divorce proceedings for misconduct theretofore committed, and that the payments to be made under the agreement were to be in no way affected by any decree of divorce, or by any subsequent marriage of either of the parties to a third party.

On December 1, 1923, the plaintiff signed a complaint in a New York court asking for an absolute divorce on the ground of her husband's adultery. An interlocutory decree was granted on March 8, 1924, which became final on November 6, 1924. On November 26, 1924, the former husband, George Mahana, transferred his residuary interest in the trust which he had set up for the plaintiff, in irrevocable trust for his second wife and his infant child by her.

In 1929 disputes arose between the plaintiff and her former husband as to which one should pay the state and federal income tax on the payments which the plaintiff was receiving under the 1923 agreement. The plaintiff instituted a suit in a New York court to construe and enforce the agreement of 1923 according to what she claimed to have been the intent of the parties. Her complaint alleged that her husband was to have paid the income taxes upon the payments to her to the extent that they would have been payable "if said $17,500 would have been her sole income." Her complaint raised other questions concerning the trust. This suit was settled by an agreement of June 28, 1933. By this agreement, the former husband agreed to pay the plaintiff the amounts by which her state and federal income taxes were increased by reason of her receipt of the $17,500 pursuant to the 1923 agreement. In connection with the new agreement, he deposited additional securities with the trustee, but he did not put them into the trust created in 1923. The income from them was to be used to supplement the income from the securities in the 1923 trust, if necessary, but he was to have complete power, so long as he was not in default under his agreement, to order the securities so deposited to be sold or exchanged.

The plaintiff paid federal income taxes for the year 1924 upon her income under the agreement, but these taxes were refunded to her by the Government, upon her claim for refund. She paid no such taxes from 1932 to 1942. The record does not show what happened between 1924 and 1932. . . .

[Section 71(a)(1)], enacted in 1942, provides:

If a wife is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, the wife's gross income includes periodic payments (whether or not made at regular intervals) received after such decree in discharge of (or attributable to property transferred, in trust or otherwise, in discharge of) a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

[Section 215 permits the husband to deduct alimony payments which are includible in the wife's income under §71. Section 682 provides that the income of certain alimony trusts is taxable to the wife.]

As shown by our findings . . . , the $17,500 received by the plaintiff in each of the years in question, 1943, 1944, and 1945, consisted of (1) money paid by the trust company out of the income of securities held by it under the 1923 agreement; (2) money similarly paid out of the income of securities held by it under the 1933 agreement; (3) money paid by George Mahana to the trust company to make up the deficit of income from the first two sources, which money was then paid by the trust company to the plaintiff. In addition, in each of the years George Mahana paid directly to the plaintiff the amounts by which the plaintiff's

income taxes had been increased by her receipt of the $17,500. Since some of these payments were made directly by the former husband, and some were made from a trust created by him for that purpose, both [§71(a)(1)] and [§682] are involved.

The plaintiff's first contention is that the legislation referred to, imposing an income tax on alimony, is unconstitutional. She says that it is not income; therefore the Sixteenth Amendment does not authorize its taxation. The argument is, at first, surprising. A large sum of money comes into the plaintiff's hands. One wonders why it is not "income" in the sense of the Sixteenth Amendment. It is income to spend, to live on, to save. Is it not also income to tax, if Congress sees fit, as it has, to tax it? But there is something to be said for the plaintiff's contention. In the case of Gould v. Gould, 245 U.S. 151, the court held that alimony paid to a divorced wife was not taxable to her as income. The legislation then in force was the Income Tax Act of 1913. It did not expressly either include or exclude alimony from its definition of what income should be taxed. The court used language which indicated that it thought that alimony was not income. The court did not purport to be deciding a constitutional question, but only a question of the interpretation of the Income Tax Act of 1913. It would have been hard to believe that Congress intended to tax the receipt of alimony by the divorced wife, when the law had already taxed the husband upon his receipt of the income from which he paid the alimony, except in the infrequent case when alimony was paid out of the husband's capital.

The plaintiff points to cases such as Douglas v. Willcutts, 296 U.S. 1, and Helvering v. Clifford, 309 U.S. 331, in which the Supreme Court has said that Congress, in the various revenue acts, has manifested its intention to use to its fullest extent the power granted it by the Sixteenth Amendment. If we take these expressions literally, then Gould v. Gould, supra, would have to be regarded as a decision that alimony could not be taxed because it was not income in the sense of the Sixteenth Amendment. But we think that even the Supreme Court should not be taken so literally when the consequence would be to nullify an act of Congress, the intention of which is clear. The Supreme Court has also said that the meaning of the word "income" in the Sixteenth Amendment and in the acts of Congress pursuant to the amendment, is that given it in common speech and every-day usage. Old Colony Railway Co. v. Commissioner, 284 U.S. 552; United States v. American Trucking Association, 310 U.S. 534. In every-day usage the plaintiff, receiving large sums of money currently from a man who ceased to be her husband more than twenty years ago, would be regarded as having an income.

We come then to the question whether the statutes, properly interpreted, tax the plaintiff's income. The plaintiff concedes that, so far as concerns the money received by her as the yield of the securities placed in trust under the 1923 agreement, Section [682] is applicable, if it is constitutional. We have quoted the section, and it requires only that there be a divorce, a trust, and the receipt from the trust of income which would have been taxable to the husband if it had not been made taxable to the wife by the section. As the plaintiff properly concedes, these conditions are fulfilled as to the yield of the 1923 trust. We think they are fulfilled also as to the yield from the additional securities deposited with the trustee in 1933, to supplement the income of those previously deposited. The plaintiff says that they were not placed in trust, but only "deposited." But they were deposited "pursuant to the agreement dated November 12, 1923, . . . to be held, sold, exchanged or otherwise disposed of by you, and in case of sale, the proceeds thereof invested. . . ." The trust company was directed to pay the income from the securities to the plaintiff, if necessary to make up the agreed $17,500. The deposit of these securities was a deposit in trust. The apparent

reason why they were not added to the 1923 trust was that, in the meantime, the plaintiff's former husband had conveyed his residuary interest in that trust to his second wife and his infant child by her, and he did not want the additional securities to be covered by that conveyance. The new securities were in a different trust, but it was a trust to pay alimony and was covered by Section [682].

As to the money which the former husband paid to the trustee to make up the deficit left when the two trusts did not yield $17,500, we think that although this money came to the plaintiff from the trustee, it was not "the income of any trust" within the meaning of Section [682]. The trustee was a mere intermediary who accepted a deposit and paid out a similar amount to the plaintiff, not as income of a trust but merely pursuant to the agreement to perform this service. If, then, these payments were taxable to the plaintiff, it was because they were covered by [§71(a)(1)] which we have quoted above. The plaintiff urges several reasons why they should not be regarded as covered by that section. The section applies to "periodic payments (whether or not made at regular intervals)." Although this language is somewhat self-contradictory, we think that it is complied with when the payments are agreed to be made and are made whenever specified external or objective conditions occur. Here the payments were to be made whenever the income of the trust was less than $17,500.

Section [71(a)(1)] requires that the payments, to be taxable, must be made:

> . . . in discharge of . . . a legal obligation, which, because of the marital or family relationship, is imposed on or incurred by the husband under the decree or under a written instrument incident to such divorce or separation.

The plaintiff says that the written instrument by which her then husband agreed to make the payments here in question was not "incident to such divorce." We think it was so incident. The plaintiff had pending a suit for legal separation and separate maintenance at the time of the agreement. The agreement said that it was for her separate maintenance and support, that it was not to be affected by any decree of divorce obtained by her, and that it was not to prejudice the right of either party to seek a divorce for misconduct which antedated the agreement. Thirteen days after the agreement was executed, the plaintiff signed her complaint asking for a decree of divorce for her husband's adultery. We have no doubt, from the timing and circumstances of the agreement, that it was the usual settlement out of court of the property rights of the parties when a divorce is contemplated. Both the plaintiff and her former husband testified in this case and neither denied what the circumstances indicate to have been the fact. The payments made by the former husband to make up the deficit were, then, periodic payments, made pursuant to an agreement incident to the parties' divorce. The payments were taxable income to the plaintiff, under the provisions of [§71(a)(1)].

The question remains as to whether the former husband's payments to the plaintiff by way of reimbursement to her of the amounts which she was obliged to pay as income tax on her alimony, after the enactment in 1942 of [§71(a)(1)], were also taxable to her under [§71(a)(1)]. The plaintiff contends that they were not, because they were paid pursuant to the 1933 agreement, which was made nine years after the divorce and was not, the plaintiff says, "incident to such divorce" in the sense of the statute. We think that the 1933 agreement was incident to the divorce. We have held above that the 1923 agreement was incident to the divorce. The 1933 agreement was, as we have seen, made in settlement of a suit by the plaintiff for the construction and enforcement of the 1923 agreement. She contended, in that suit, that her former husband was, under the 1923 agreement, obligated to reimburse her for income taxes paid "as if said $17,500 would have been her sole income." In the 1933 agreement, her former husband

promised to do more than that; he promised to reimburse her by the amount which her income taxes were actually increased by her receipt of the $17,500. For this concession, he received concessions from her which made him willing to enter into the 1933 agreement. But the whole agreement was made to clarify the 1923 agreement, so that the disputes as to its meaning which had, in 1933, been going on for some years, could be avoided. The plaintiff had no rights against her former husband in 1933 except those that were given her by the 1923 agreement. The rights which she got under the 1933 agreement were, with mutually satisfactory additions and subtractions, those to which she was entitled under the 1923 agreement. We think, therefore, that the reimbursements to her of her income taxes paid by her on her alimony were made pursuant to a written instrument which was incident to her divorce.

The Government urges, as an additional reason for reaching the same conclusion, that we interpret the language of [§71(a)(1)] as meaning that the written instrument referred to need only be incident to the fact that there had been a divorce, and not to the decree of divorce. The Tax Court, in Dauwalter v. Commissioner, 9 T.C. 580, has rejected this interpretation. Compare Commissioner v. Murray, 2 Cir., 174 F.2d 816. See also Cox v. Commissioner, 3 Cir., 176 F.2d 226, for a treatment of this question, and of the history and purpose of the 1942 legislation relating to the taxation of alimony. In view of our conclusion that the 1933 agreement, through its connection with the 1923 agreement, was incident to the decree of divorce, we do not pass upon this contention of the Government as to the interpretation of [§71(a)(1)].

The plaintiff's petition will be dismissed. It is so ordered.

JONES, Chief Judge, and HOWELL, WHITAKER, and LITTLEJOHN, JJ., concur.

NOTE

1. *History.* As the foregoing case indicates, prior to the statutory revision of 1942, Gould v. Gould, 245 U.S. 151 (1917), had held that alimony payments were not taxable to the wife. Nor were the payments deductible by the husband, since there was no statutory authorization for a deduction. If the husband transferred property to a trust to pay the income as alimony, the trust income continued to be taxable to him because applied to pay his debts. The husband's only escape was to make a lump sum transfer of property to discharge his obligation of support once and for all; if under local law the husband's support obligation could be terminated in this manner, the income from the property would thereafter be taxed to the ex-wife. Helvering v. Fuller, 310 U.S. 69 (1940). If local law, a want of capital, the ex-wife's resistance, or other reasons made such a termination of his obligation of support impossible, the husband under the impact of rising tax rates might be left with little or no income of his own, especially if his misalliances had been lavish in number or in cost. These facts led to the 1942 revision.

In Twinam v. Commissioner, 22 T.C. 83 (1954), the Tax Court agreed with the reasoning of the *Mahana* case on the constitutional issue, and added two arguments of its own: (a) Gould v. Gould held in 1917 that alimony was not taxable to the wife on statutory grounds; Congress did not change the statute during the following eighteen years; hence Douglas v. Willcuts should not be read as a comment on the constitutional question. (b) By analogy to Poe v. Seaborn, infra page 330, the ex-wife can be properly taxed on that part of the husband's income that is paid to and enjoyed by her, at least if he receives a corresponding deduction for the payments.

2. *Husband's right to deduct payments.* Under §215, the husband may deduct alimony payments only when they are taxed to the wife under §71. (The terms "husband" and "wife" are interchangeable in the alimony sections, by virtue of §7701(a)(17), so that if the wife is paying alimony, she may deduct the payments and the husband is taxed on them.)

If the husband uses appreciated property to discharge his obligations to his ex-wife, he may realize gain on the transfer. See the *Davis* case, infra page 432.

3. *Pre-1954 requirement of "decree" of divorce or separate maintenance.* Until 1954,

payments were deductible by the husband and taxable to the wife only if they were divorced or legally separated under a "decree" of divorce or of separate maintenance; an out-of-court separation agreement would not suffice. The requirement of a legal decree was adopted to prevent collusive separation agreements for the purpose of splitting income between husband and wife. Even if this dismal view of human nature was correct, it became irrelevant with the enactment of the Revenue Act of 1948, permitting married couples to split their income for tax purposes by filing a joint return (infra p. 334). Moreover, the income-splitting provisions of the 1948 Act created a dilemma for many taxpayers who were living apart from their spouses under informal separation agreements: although they can file joint returns because they are not divorced or separated under a legal decrees — see §6013(a) and (d) — it is often not feasible for them to do so because both must sign the return and assume liability for payment of the entire tax and of any deficiency that may be assessed subsequently.* Since collusive separation agreements were no longer a threat to the revenue, therefore, in 1954 Congress enacted §71(a)(2), permitting payments under a "written separation agreement" to qualify as alimony, even though there is no decree of divorce or of separate maintenance. Because the pre-1954 tax law may have been taken into account in fixing the amount of support to be paid by the husband, however, §71(a)(2) applies only to agreements executed after the 1954 Code was enacted. See Regs. §1.71(b)(2) on the effect of a post-1954 material modification of a pre-1954 agreement.

When §71(a)(1) rather than §71(a)(2) is controlling, note that the payments must discharge a legal obligation arising "under the decree" or "under a written instrument incident to such divorce or separation." If the husband's obligation is imposed by a decree, the payments will qualify. They will also qualify if an agreement between the spouses is incorporated in the decree. But sometimes the amount of support is fixed by a separation or other agreement that makes no mention of divorce (possibly to avoid a charge of collusion) and, because of the agreement, the actual decree makes no provision for support. As the last paragraph of the *Mahana* case indicates, some cases have held that the written instrument must be incident to the decree of divorce or legal separation, others that it need only be incident to the status of the parties. A series of cases in the Court of Appeals for the Second Circuit supporting the "status" theory has been endorsed by other appellate courts and by the Regulations, and the Tax Court — the principal exponent of the "decree" theory — has now fallen in line. Holt v. Commissioner, 226 F.2d 757 (2d Cir. 1955), cert. denied, 350 U.S. 982; Regs. §1.71-1(b); Cramer v. Commissioner, 36 T.C. 1136 (1961). The issue is now less important than it was before 1954, since if the payments are made under a post-1954 written separation agreement, they can qualify under §71(a)(2) even if they are not "incident" to divorce or separate maintenance.

As to post-divorce amendments to pre-divorce agreements, see Rev. Ruls. 60-140, 60-141, and 60-142, 1960-1 C.B. 31, 33, and 34.

4. *Support paid under court order.* Section 71(a)(3), enacted in 1954, taxes the wife on support payments received under a court order, and §215 allows the husband a correlative deduction. In the alternative, they may file a joint return; but the enactment of §71(a)(3) acknowledges that if relations have so deteriorated that a judicial support order is necessary they are unlikely to meet amicably to sign a joint return.

5. *Periodic vs. lump sum payments.* Section 71(a) applies only to "periodic payments (whether or not made at regular intervals)" and §71(c)(1) provides that this term does not include "installment payments discharging a part of an obligation the principal sum of which is, either in terms of money or property, specified in the decree, instrument, or agreement," subject to the exception in §71(c)(2) for a principal sum that is to be paid over a period of more than ten years. If the parties agree on a lump sum settlement of $50,000 in lieu of annual payments for support, it is not taxed to the wife or deductible by the husband. Why does §71(a) make this distinction between such settlements and periodic payments? Note that the same result would follow if the husband agreed to pay $5000 per year for ten years, unless the installment payments were to terminate upon a change in the economic status or the death of either spouse, or on the wife's remarriage. See Regs. §1.71-1(d)(3)(i).

* For an agreement between estranged spouses for the filing of a joint return, replete with protective clauses, see Herrmann v. Commissioner, ¶64,061 P-H Memo TC.

It has been held that a lump sum non-recurring payment by the husband to defray the wife's legal expenses incident to the divorce or the medical expenses for which she would become liable in the following year is not a "periodic payment," but the Internal Revenue Service has ruled that if the husband agrees to defray his wife's medical expenses until her remarriage or death, the payments are deductible. Rev. Rul. 62-106, 1962-2 C.B. 21.

For some other problems in this area, see Spicknall's Estate v. Commissioner, 285 F.2d 561 (8th Cir. 1961); Furrow v. Commissioner, 292 F.2d 604 (10th Cir. 1961); Rev. Rul. 60-250, 1960-2 C.B. 435.

6. *Payment of insurance premiums.* Alimony decrees and agreements often require the husband to keep insurance on his life in force by regular payments of premiums directly to the insurance company. The ex-wife may be the beneficiary of the policy and have all the incidents of ownership, in which event the husband's payments of premiums will be deductible by him and taxable to her (assuming the other statutory requirements are satisfied), or she may have only a limited, contingent, or security interest in the policy, in which event the premiums will ordinarily not constitute payments within the meaning of §71. For applications of these principles, see Hyde v. Commissioner, 301 F.2d 279 (2d Cir. 1962), and the cases there cited.

7. *Property settlements.* Section 71(a)(1) speaks of "a legal obligation which, because of the marital or family relationship, is imposed on or incurred by the husband," etc., and a similar phrase is to be found in §71(a)(2). The Regulations provide that §71(a) is concerned with "payments made because of the family or marital relationship in recognition of the general obligation to support," and that it does not include a payment which serves, for example, to discharge a bona fide loan made previously by the husband to the wife or a payment in discharge of the wife's interest in jointly owned property. The distinction may be difficult to apply, especially in community property jurisdictions. Riddell v. Guggenheim, 281 F.2d 836 (9th Cir. 1960); Soltermann v. United States, 272 F.2d 387 (9th Cir. 1959); Blate v. Commissioner, 34 T.C. 121 (1960); Bardwell v. Commissioner, 318 F.2d 786 (10th Cir. 1963).

8. *Support of children.* Amounts "payable for the support of minor children" are not taxed to the wife or deductible by the husband. Regs. §1.71-1(e) speaks of an amount "specifically designated" as payable for minor children, and the Supreme Court in Commissioner v. Lester, 366 U.S. 299 (1961), held that this restriction applies only to amounts that are "specifically earmarked" for the children. If the husband is required to pay $500 monthly to the wife, with a reduction to $400 when a minor child reaches his majority or dies, he can deduct the entire amount; before the *Lester* case, there was some authority for allowing him to deduct only $400 on the ground that $100 was intended for the child, especially if local law imposed an obligation on the wife to use that part of the payment for the child's benefit.

What is the status of amounts which the husband must pay for the support of persons other than his minor children? Note that in the *Mahana* case, the husband was to provide support for the taxpayer's mother; see also Faber v. Commissioner, 264 F.2d 127 (3d Cir. 1959) (stepchild who had not been adopted by taxpayer).

While the husband cannot deduct amounts fixed for the support of minor children, he can use them as the basis for a dependency deduction under §151(e). But such a deduction requires proof that he furnished more than half of the child's support, §152(a), and the husband's claim sometimes fails for lack of proof, especially if the ex-wife is uncooperative in supplying the financial information. See, e.g., Sijan v. Commissioner, ¶55,287 P-H Memo T.C. ("Petitioner [the ex-husband] is in the unfortunate position of having to rely upon the testimony of his divorced wife for proof of the total amount expended in maintaining the children, who lived with her. Even granting [that her] testimony may have been exaggerated and unreliable . . . if we discard it the record is barren of any evidence in this vital area"); Lagomarcino, The Divorced Husband and the Dependency Exemption Mirage: An Outline of the Problem and of a Statutory Corrective Procedure, 12 Tax L. Rev. 85 (1956); infra page 338.

9. *Tax-reimbursement agreements.* As the *Mahana* case demonstrates, if the husband is to pay a stated sum annually, plus the ex-wife's tax thereon, the latter amount, as well as the former, will be alimony, deductible by the husband and taxable to the wife. See Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929). Under the 1933 agreement, would

the husband have to pay the tax caused by the ex-wife's receipt of $17,500 no matter how much other income she received? Note that if the agreement or decree is construed to require the husband to discharge the wife's tax on the amount he paid to discharge her tax on the primary payment, there will be one more deduction for the husband and item of income for the wife. And so on. The same problem can arise, and the same principle is applicable, when an employer agrees to pay his employee's income taxes, when a lessee of property agrees to pay the lessor's taxes on the rent, etc. The Internal Revenue Service has announced that it will not concern itself with the mechanics by which the parties settle such obligations inter sese; i.e., it will accept their determination of the number of rounds for which the computation of reimbursement is made. Mim. 6779, 1952-1 C.B. 8, as modified by IR-Mim. 51, 1952-2 C.B. 65; Connecticut Ry. & Lighting Co. v. United States, 142 F. Supp. 907 (Ct. Cl. 1956); Safe Harbor Water Power Corp. v. United States, 303 F.2d 928 (Ct. Cl. 1962). See Brown, Shifting the Burden of Income Taxes by Contract, 96 U. of Pa. L. Rev. 822 (1948); Kades, Phantom Income: Net Leases and the Clark Case, 5 Syracuse L. Rev. 18 (1953). Section 110, new in the 1954 Code, alters the rule as to pre-1954 net leases.

10. *Impact of federal tax rules.* The alimony sections are a good example of how an entire area of legal practice may become tax-dominated. The negotiations for alimony, especially in the higher brackets, will be governed in an important degree by the tax status of each party, and the agreement itself must be drafted with §71's technical requirements in sight.

11. *References.* Wren, Tax Problems Incident to Divorce and Property Settlements, 49 Calif. L. Rev. 665 (1961); Holland, Piper, Bailey, and Sander, Matrimony, Divorce and Separation, 18 N.Y.U. Inst. on Fed. Taxation 901 (1960); Walther and Wittman, Separation and Divorce in Louisiana: A Tax Analysis, 12 Tul. Tax Inst. 488 (1963), reprinted in 37 Tul. L. Rev. 1 (1962); Whinery, Tax and Non-tax Negotiations in Alimony and Support After the Lester Case, 15 Okla. L. Rev. 1 (1962); Comment, Federal Income Taxation of Support Payments Under Post-divorce Original Agreements, 69 Yale L.J. 153 (1959); Horne, Tax Pitfalls in Alimony and Separation Payments, 35 Taxes 751 (1957); Kragen, Stoke, Oliver, and Buckley, The Marriage Undone: Taxwise, 42 Calif. L. Rev. 408 (1954); Rosenfeld and Raskin, Drafting a Property Settlement Agreement Under the 1954 Code, 1956 So. Calif. Tax Inst. 675 and 713; Rudick, Marriage, Divorce and Taxes, 2 Tax L. Rev. 123 (1947); Rosenkranz, Divorce and the Federal Income Tax, 16 U. of Fla. L. Rev. 1 (1963).

4. *Interest*

Section 163(b), permitting interest on the taxpayer's indebtedness to be deducted, is a re-enactment of §23(b) of the 1939 Code.

Section 163(b) (relating to interest on certain installment purchases) is new in the 1954 Code.

KNETSCH v. UNITED STATES
364 U.S. 361 (1960)

MR. JUSTICE BRENNAN delivered the opinion of the Court.

This case presents the question of whether deductions from gross income claimed on petitioners' 1953 and 1954 joint federal income tax returns, of $143,465 in 1953 and of $147,105 in 1954, for payments made by petitioner, Karl F. Knetsch, to Sam Houston Life Insurance Company, constituted "interest paid . . . on indebtedness" within the meaning of §23(b) of the Internal Revenue Code of 1939 and §163(a) of the Internal Revenue Code of 1954. The Commissioner of Internal Revenue disallowed the deductions and determined a deficiency for each year. The petitioners paid the deficiencies and brought this action for refund in the District Court for the Southern District of California. The District Court rendered judgment for the United States, and the Court of Appeals for the Ninth

Circuit affirmed, 272 F.2d 200. Because of a suggested conflict with the decision of the Court of Appeals for the Fifth Circuit in United States v. Bond, 258 F.2d 577, we granted certiorari, 361 U.S. 958.

On December 11, 1953, the insurance company sold Knetsch ten 30-year maturity deferred annuity savings bonds, each in the face amount of $400,000 and bearing interest at 2½% compounded annually. The purchase price was $4,004,000. Knetsch gave the Company his check for $4,000, and signed $4,000,000 of nonrecourse annuity loan notes for the balance. The notes bore 3½% interest and were secured by the annuity bonds. The interest was payable in advance, and Knetsch on the same day prepaid the first year's interest, which was $140,000. Under the Table of Cash and Loan Values made part of the bonds, their cash or loan value at December 11, 1954, the end of the first contract year, was to be $4,100,000. The contract terms, however, permitted Knetsch to borrow any excess of this value above his indebtedness without waiting until December 11, 1954. Knetsch took advantage of this provision only five days after the purchase. On December 16, 1953, he received from the company $99,000 of the $100,000 excess over his $4,000,000 indebtedness, for which he gave his notes bearing 3½% interest. This interest was also payable in advance and on the same day he prepaid the first year's interest of $3,465. In their joint return for 1953, the petitioners deducted the sum of the two interest payments, that is $143,465, as "interest paid . . . within the taxable year on indebtedness," under §23(b) of the 1939 Code.

The second contract year began on December 11, 1954, when interest in advance of $143,465 was payable by Knetsch on his aggregate indebtedness of $4,099,000. Knetsch paid this amount on December 27, 1954. Three days later, on December 30, he received from the company cash in the amount of $104,400, the difference less $1,000 between his then $4,099,000 indebtedness and the cash or loan value of the bonds of $4,204,000 on December 11, 1955. He gave the company appropriate notes and prepaid the interest thereon of $3,640. In their joint return for the taxable year 1954 the petitioners deducted the sum of the two interest payments, that is $147,105, as "interest paid . . . within the taxable year on indebtedness," under §163(a) of the 1954 Code.

The tax years 1955 and 1956 are not involved in this proceeding, but a recital of the events of those years is necessary to complete the story of the transaction. On December 11, 1955, the start of the third contract year, Knetsch became obligated to pay $147,105 as prepaid interest on an indebtedness which now totalled $4,203,000. He paid this interest on December 28, 1955. On the same date he received $104,000 from the company. This was $1,000 less than the difference between his indebtedness and the cash or loan value of the bonds of $4,308,000 at December 11, 1956. Again he gave the company notes upon which he prepaid interest of $3,640. Petitioners claimed a deduction on their 1955 joint return for the aggregate of the payments, or $150,745.

Knetsch did not go on with the transaction for the fourth contract year beginning December 11, 1956, but terminated it on December 27, 1956. His indebtedness at that time totalled $4,307,000. The cash or loan value of the bonds was the $4,308,000 value at December 11, 1956, which had been the basis of the "loan" of December 28, 1955. He surrendered the bonds and his indebtedness was canceled. He received the difference of $1,000 in cash.

The contract called for a monthly annuity of $90,171 at maturity (when Knetsch would be 90 years of age) or for such smaller amount as would be produced by the cash or loan value after deduction of the then existing indebtedness. It was stipulated that if Knetsch had held the bonds to maturity and continued annually to borrow the net cash value less $1,000, the sum available for the annuity

at maturity would be $1,000 ($8,388,000 cash or loan value less $8,387,000 of indebtedness), enough to provide an annuity of only $43 per month.

The trial judge made findings that "[t]here was no commercial economic substance to the . . . transaction," that the parties did not intend that Knetsch "become indebted to Sam Houston," that "[n]o indebtedness of [Knetsch] was created by any of the . . . transactions," and that "[n]o economic gain could be achieved from the purchase of these bonds without regard to the tax consequences. . . ." His conclusion of law, based on this Court's decision in Deputy v. du Pont, 308 U.S. 488, was that "[w]hile in form the payments to Sam Houston were compensation for the use or forbearance of money, they were not in substance. As a payment of interest, the transaction was a sham."

We first examine the transaction between Knetsch and the insurance company to determine whether it created an "indebtedness" within the meaning of §23(b) of the 1939 Code and §163(a) of the 1954 Code, or whether, as the trial court found, it was a sham. We put aside a finding by the District Court that Knetsch's "only motive in purchasing these 10 bonds was to attempt to secure an interest deduction." [1] As was said in Gregory v. Helvering, 293 U.S. 465, 469: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."

When we examine "what was done" here, we see that Knetsch paid the insurance company $294,570 during the two taxable years involved and received $203,000 back in the form of "loans." What did Knetsch get for the out-of-pocket difference of $91,570? In form he had an annuity contract with a so-called guaranteed cash value at maturity of $8,388,000, which would produce monthly annuity payments of $90,171, or substantial life insurance proceeds in the event of his death before maturity. This, as we have seen, was a fiction, because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000.[2] Plainly, therefore, Knetsch's transaction with the insurance company did "not appreciably affect his beneficial interest except to reduce his tax. . . ." Gilbert v. Commissioner, 248 F.2d 399, 411 (dissenting opinion). For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly "lent" back was in reality only the rebate of a substantial part of the so-called "interest" payments. The $91,570 difference retained by the company was its fee for providing the façade of "loans" whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of $233,297.68. There may well be single-premium annuity arrangements with nontax substance which create an "indebtedness" for the purposes of §23(b) of the 1939 Code and §163(a) of the 1954 Code. But this one is a sham.

The petitioners contend, however, that the Congress in enacting §264 of the 1954 Code authorized the deductions. They point out that §264(a)(2) denies a deduction for amounts paid on indebtedness incurred to purchase or carry a single-premium annuity contract, but only as to contracts purchased after March 1, 1954. The petitioners thus would attribute to Congress a purpose to allow

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1 We likewise put aside Knetsch's argument that, because he received ordinary income when he surrendered the annuities in 1956, he has suffered a net loss even if the contested deductions are allowed, and that therefore his motive in taking out the annuities could not have been tax avoidance.

2 Petitioners argue further that in 10 years the net cash value of the bonds would have exceeded the amounts Knetsch paid as "interest." This contention, however, is predicated on the wholly unlikely assumption that Knetsch would have paid off in cash the original $4,000,000 "loan."

the deduction of pre-1954 payments under transactions of the kind carried on by Knetsch with the insurance company without regard to whether the transactions created a true obligation to pay interest. Unless that meaning plainly appears we will not attribute it to Congress. "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." Gregory v. Helvering, supra, p. 470. We, therefore, look to the statute and materials relevant to its construction for evidence that Congress meant in §264(a)(2) to authorize the deduction of payments made under sham transactions entered into before 1954. We look in vain.

Provisions denying deductions for amounts paid on indebtedness incurred to purchase or carry insurance contracts are not new in the revenue acts. A provision applicable to all annuities, but not to life insurance or endowment contracts, was in the statute from 1932 to 1934, 47 Stat. 179. It was added at a time when Congress was developing a policy to deny a deduction for interest allocable to tax-exempt income; the proceeds of annuities were excluded from gross income up to the amount of the consideration paid in by the annuitant. See H.R. Rep. No. 708, 72d Cong., 1st Sess., p. 11. The provision was repealed by the Revenue Act of 1934, 48 Stat. 688, when the method by which annuity payments were taken into gross income was changed in such way that more would be included. 48 Stat. 687. See S. Rep. No. 558, 73d Cong., 2d Sess., p. 24.

Congress then in 1942 denied a deduction for amounts paid on indebtedness incurred to purchase single-premium life insurance and endowment contracts. This provision was enacted by an amendment to the 1939 Code, 56 Stat. 827, "to close a loophole" in respect of interest allocable to partially exempt income. See Hearings before Senate Finance Committee on H.R. 7378, 77th Cong., 2d Sess., p. 54; §22(b)(1) of the 1939 Code. . . .

The 1954 provision extending the denial to amounts paid on indebtedness incurred to purchase or carry single-premium annuities appears to us simply to expand the application of the policy in respect of interest allocable to partially exempt income. The proofs are perhaps not as strong as in the case of life insurance and endowment contracts, but in the absence of any contrary expression of the Congress, their import is clear enough. There is *first* the fact that the provision was incorporated in the section covering life insurance and endowment contracts, which unquestionably was adopted to further that policy. There is *second* the fact that Congress' attention was directed to annuities in 1954; the same 1954 statute again changed the basis for taking part of the proceeds of annuities into gross income. See §72(b) of the 1954 Code. These are signs that Congress' long-standing concern with the problem of interest allocable to partially exempt income, and not any concern with sham transactions, explains the provision.*

Moreover the provision itself negates any suggestion that sham transactions were the congressional concern, for the deduction denied is of certain interest payments on actual "indebtedness." And we see nothing in the Senate Finance and House Ways and Means Committee Reports on §264, H.R. Rep. No. 1337, 83d Cong., 2d Sess., p. 31; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 38, to suggest that Congress in exempting pre-1954 annuities intended to protect sham transactions.

Some point is made in an amicus curiae brief of the fact that Knetsch in enter-

* In 1964, Congress acted again in this field, by enacting §264(a)(3), which disallows (subject to certain exceptions) any deduction for interest on indebtedness incurred or continued to purchase or carry a life insurance, endowment, or annuity contract pursuant to a plan which "contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of such contract." — ED.

ing into these annuity agreements relied on individual ruling letters issued by the Commissioner to other taxpayers. This argument has never been advanced by petitioners in this case. Accordingly, we have no reason to pass upon it.

The judgment of the Court of Appeals is

Affirmed.

MR. JUSTICE DOUGLAS, with whom MR. JUSTICE WHITTAKER and MR. JUSTICE STEWART concur, dissenting.

I agree with the views expressed by Judge Moore in Diggs v. Commissioner, 281 F.2d 326, 330-332, and by Judge Brown, writing for himself and Judge Hutcheson, in United States v. Bond, 258 F.2d 577.

It is true that in this transaction the taxpayer was bound to lose if the annuity contract is taken by itself. At least the taxpayer showed by his conduct that he never intended to come out ahead on that investment apart from this income tax deduction. Yet the same may be true where a taxpayer borrows money at 5% or 6% interest to purchase securities that pay only nominal interest; or where, with money in the bank earning 3%, he borrows from the selfsame bank at a higher rate. His aim there, as here, may only be to get a tax deduction for interest paid. Yet as long as the transaction itself is not hocus-pocus, the interest charges incident to completing it would seem to be deductible under the Internal Revenue Code as respects annuity contracts made prior to March 1, 1954, the date Congress selected for terminating this class of deductions. 26 U.S.C. §264. The insurance company existed; it operated under Texas law; it was authorized to issue these policies and to make these annuity loans. While the taxpayer was obligated to pay interest at the rate of 3½% per annum, the annuity bonds increased in cash value at the rate of only 2½% per annum. The insurance company's profit was in that 1-point spread.

Tax avoidance is a dominating motive behind scores of transactions. It is plainly present here. Will the Service that calls this transaction a "sham" today not press for collection of taxes[1] arising out of the surrender of the annuity contract? I think it should, for I do not believe any part of the transaction was a "sham." To disallow the "interest" deduction because the annuity device was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here. The remedy is legislative. Evils or abuses can be particularized by Congress. We deal only with "interest" as commonly understood and as used across the board in myriad transactions. Since these transactions were real and legitimate in the insurance world and were consummated within the limits allowed by insurance policies, I would recognize them tax-wise.

NOTE

1. *Bona fide "indebtedness."* Until recent years, most of the litigation over the bona fides of the alleged indebtedness concerned intra-family transactions. See, for example, Mercil v. Commissioner, 24 T.C. 1150 (1955) (monthly payments to taxpayer's elderly father as "interest" on alleged indebtedness growing out of father's payment for taxpayer's education many years earlier; held, not deductible); Gilman v. Commissioner, 53 F.2d 47 (8th Cir. 1931) (payments on promissory notes given by taxpayer to his wife and children; held, not deductible). Another area of continuing friction is the payment of "interest" by a one-man or closely held corporation to its owners, where the issue is whether their

[1] Petitioners terminated this transaction in 1956 by allowing the bonds to be cancelled and receiving a check for $1,000. The termination was reflected in their tax return for 1956. It might also be noted that the insurance company reported as gross income the interest payments which it received from petitioners in 1953 and 1954.

advances to the corporation constitute loans (the interest on which is deductible) or equity investments (dividends on which are not deductible); see page 642 infra.

In the *Knetsch* case, the taxpayer was charged interest at the rate of 3½ per cent on his loan while his investment grew at the rate of only 2½ per cent. Unless a drastic change in economic conditions made it possible for him to borrow funds at less than 2½ per cent and pay off the outstanding loan, he could not achieve an economic gain. But the transaction could nevertheless produce a profit *if* the interest paid was deductible from high-bracket income and *if* the increase in cash surrender value was taxable at the capital gains rate. (On the latter assumption, see footnote 1 of the *Knetsch* opinion.) On these assumptions, the result for which the taxpayer hoped is thus explained by Blum, Knetsch v. United States: A Pronouncement on Tax Avoidance, 1961 Supreme Court Review 135, also in 40 Taxes 296 (1962):

> For the almost four years covered by the transaction, the taxpayer paid in cash interest totalling $441,315, and he received in cash $308,000 through loans against the cash surrender value and the sum received upon surrender of the bonds. He thus was out of pocket (1) the difference between these two amounts, $133,315, plus (2) his initial $4,000 cash investment, a total of $137,315. If, for purposes of illustration, it is assumed that all of the income to be offset by the interest deduction would otherwise have been taxed in the 90% bracket, the net cost to the taxpayer would have been the initial cash investment ($4,000) plus 10% of the interest (10% of $441,315 = $44,131.50), a total of $48,131.50. And if further it is assumed that the increase in cash value could have been realized as a long-term capital gain, bearing a maximum tax of 25%, the net received after tax would have been $231,000 (75% of $308,000). The taxpayer's net profit after tax then would have been $192,868.50 — or better than 140% of his total cash outlay of $137,315.

Although the amounts would have been different if the arrangement had been kept alive for a longer period, the same principle would have been applicable. There have been a great many other cases in recent years involving transactions that offered little or no hope of profit unless a claimed deduction for interest was allowed and a partially offsetting future gain would be taxable as capital gain. The transactions are so complex, however, that even a summary would be very lengthy. See Bridges v. Commissioner, 39 T.C. 1064 (1963), and cases there cited; Eustice and Lyon, Federal Income Taxation, 36 N.Y.U.L. Rev. 642, 643 et seq. (1961).

Transactions of this type are sometimes devised by brokers, insurance agents, and promoters who derive a commission from acting as middleman in the purchase or sale of the insurance policies or securities involved. In Miles v. Livingstone, 301 F.2d 99 (1962), a civil action against a dealer in government securities, brought by a customer who failed to attain the tax advantages he had anticipated, was dismissed; the court agreed that the transactions were "spurious and without substance," but held that the plaintiff knew this as well as the defendant. In Anderson v. Knox, 297 F.2d 702 (9th Cir. 1961), however, the court affirmed a judgment against an insurance agent for breaching a warranty that an elaborate plan for bank-financed insurance "was a suitable program for plaintiff and his family and suited their needs," in which the plaintiff recovered his out-of-pocket expenses plus punitive damages of $10,000 and $2500 for emotional distress. See also Martin v. Livingstone Securities Corp., 219 F. Supp. 200 (D. Mass. 1963).

2. *Indebtedness to buy or carry tax-exempt securities.* Section 265(2) disallows the deduction for interest on indebtedness "incurred or continued" to purchase tax-exempt securities. Note that it is applicable only if the interest received is *wholly* tax exempt; the interest on some federal obligations is exempt from the normal tax but not from the surtax. (Supra p. 161.) How is the causal connection to be established, especially as to indebtedness "continued" for the forbidden purpose? See Jacobson v. Commissioner, 28 T.C. 579 (1957).

The prohibition of §265(2) was attacked in Denman v. Slayton, 282 U.S. 514 (1931), on the ground that it defeated the immunity of tax-exempt securities and discriminated against persons of limited means who had to borrow to purchase them. The Court upheld the provision, saying (282 U.S. at 519-520):

The respondent here was not in effect required to pay more upon his taxable receipts than was demanded of others who enjoyed like incomes solely because he was the recipient of interest from tax free securities. . . . Under the theory of the respondent, A, with an income of $10,000 arising from non-exempt securities by the simple expedient of purchasing exempt ones with borrowed funds and paying $10,000 interest thereon, would escape all taxation upon receipts from both sources. It was proper to make provision to prevent such a possibility.

3. *Debt on cooperative apartment.* The Code was amended in 1942 to allow the tenant-stockholder of a cooperative apartment building to deduct his share of the corporation's interest and taxes and in 1954 the provision, now §216, was broadened to include cooperative housing developments. See Holden v. Commissioner, 27 B.T.A. 530 (1933), holding that the tenant could not take an interest deduction for a pre-1942 year, because the interest and taxes were the obligation of the cooperative corporation that owned the building; the tenant's obligation to defray his share of the corporation's expenses did not convert his payments into payments of "interest" and "taxes."

4. *Hidden interest on installment purchases.* Section 163(b) allows a deduction for "hidden" interest on installment purchases. Before 1954, this area was in some doubt. See McKenzie v. Commissioner, ¶52,126 P-H Memo T.C.; cf. Hundahl v. Commissioner, 118 F.2d 349 (5th Cir. 1941).

For problems in allocating a lump sum payment on account of an existing debt between principal and interest, see Rev. Rul. 63-57, 1963-1 C.B. 103; see also §483, enacted in 1964 to require interest to be imputed in certain sales of property where payment is deferred (infra page 521).

5. *The rationale of §163(a).* Interest may be incurred in business or in a transaction entered into for profit; and the deduction in such circumstances rests upon the same footing as any other expense of business or investment; see page 204n infra. But it may also be a purely personal expense, as when paid to finance the purchase of one's private residence or car. Why should such expenses be deductible when the cost of rent, food, and clothing is not?

5. *Taxes*

Section 164, allowing certain taxes to be deducted, was derived from §23(c) of the 1939 Code, but it was substantially amended in 1964.

Before 1964, most state and local and some federal taxes were deductible by virtue of §164, but in 1964 this provision was amended to permit only the following taxes to be deducted:

1. State, local, and foreign real property taxes.
2. State and local personal property taxes.
3. State, local, and foreign income taxes (including war profits and excess profits taxes).
4. State and local general sales taxes. For the meaning of the term "general sales tax," see §164(b)(2).
5. State and local taxes on the sale of gasoline and other motor fuels.

These taxes may be deducted even though incurred in connection with the taxpayer's personal residence or other living expenses. In addition, taxes that are incurred in his trade or business or other profit-seeking activities may be deducted under §162 (ordinary and necessary business expenses) or §212 (property held for production of income).

NOTE

1. *Apportionment of real property taxes.* Suppose the real property tax on A's home for the calendar year 1965 is based on its assessed value as of June 30, 1964, and must be

paid in full before June 30, 1965. A pays the tax on June 1, 1965, but sells his house on July 1, 1965, the buyer paying the agreed price plus 50 per cent of the 1965 tax. See §164(d), which, when applicable, overrules Magruder v. Supplee, 316 U.S. 394 (1942); Cannon, The Apportionment of Real Estate Taxes Between Purchaser and Seller Under Section 164(d) of the 1954 Code, 12 Tax L. Rev. 433 (1957).

2. *Taxes on exempt income.* If state or foreign income taxes are imposed on income that is exempt from federal taxation, is a deduction for the state or foreign taxes denied by §265(1)? Note that this provision uses the term "expenses" in its title, but that its language embraces "any amount otherwise allowable as a deduction." A series of Tax Court cases has held that taxes may be disallowed under §265(1); they are cited in Hawaiian Trust Co. Ltd. v. United States, 291 F.2d 761 (9th Cir. 1961), which also discusses whether gains that are not "recognized" for federal tax purposes are "exempt" within the meaning of §265 so as to result in disallowance of state taxes allocable to such gains.

3. *Recovery of taxes after deduction.* If the taxpayer succeeds in obtaining a refund of taxes that he deducted under §164, he must report the refund as income, unless he derived no tax benefit from the deduction. See Perry v. United States, supra page 75; §111.

6. *Casualty Losses*

Section 165(a) and (c)(3), allowing a deduction for casualty losses sustained by individuals, and §165(b), prescribing the method of determining the amount of a loss deduction, are derived from §23(e)(3) and §23(i) of the 1939 Code.

Section 165(e), prescribing the time for deducting losses by theft, and §165(h), relating to the time for deducting disaster losses, are new.

KEENAN v. BOWERS
91 F. Supp. 771 (E.D.S.C. 1950)

WYCHE, Chief Judge. . . .

On March 15, 1945, the taxpayers, husband and wife, filed a joint federal income tax return for the tax year 1944, and in their computation of net taxable income claimed a deduction of $1,300 under [§165(c)(3)], for the loss of two diamond rings not compensated for by insurance, which deduction was disallowed by the Commissioner, and an assessment made for additional taxes in the amount of $972.02, plus $180.38 interest, which was paid under protest by plaintiffs. A claim for refund was duly filed by plaintiffs and disallowed.

The stipulation by the parties and the affidavit of Mrs. Keenan, which was agreed to be considered as testimony for the plaintiff, disclose the following facts: On or about May 4, 1944, Mr. and Mrs. W. J. Keenan, the plaintiffs herein, were en route to visit their son at Grenada, Mississippi, prior to his departure overseas with the 94th Infantry, and they stopped and spent the night at the Bankhead Hotel in Birmingham, Alabama; they had never spent the night in said hotel before and the surroundings were strange to both of them; their hotel room had single beds with a small lamp table between the beds. This arrangement differed from that in their home where they had bed tables on each side. On this night, Mr. Keenan prepared for bed, and being bothered with a nose irritation, placed a box of kleenex tissues on his side of the bed table and went to sleep prior to Mrs. Keenan. Subsequent to this, his wife retired. Customarily, when retiring at home, Mrs. Keenan removed her rings and placed them on or in her bureau, but this night she did not do so. However, during the night, she found her rings uncomfortable, and recalling the box of kleenex on the table, she reached out in the

dark and unbeknown to her husband, took a piece of kleenex and wrapped her rings in it, and placed them wrapped on her side of the small table; she wrapped them in kleenex tissue with the thought in mind that this would be a possible precaution against the theft of the rings; during the night, Mr. Keenan awoke several times, used pieces of kleenex tissues to blow his nose, and having no convenient waste basket at hand, placed these balls of tissue on the table, intending to dispose of them upon rising; the next morning, Mr. Keenan arose early and prior to his wife's awakening, hastily preparing for an early departure, swept the used tissues up, not knowing that some of them contained the rings, balled them up, went to the bathroom and disposed of them in the toilet, flushing it forthwith; about a half an hour after Mr. Keenan's actions, Mrs. Keenan realized what had happened and immediately communicated with the hotel manager who called in the hotel engineer. A search of the trap was to no avail and then later the City of Birmingham's engineer went into the large trap in the sewer into which the hotel refuse emptied but all efforts to recover the rings were unavailing. The value of these rings, less the maximum amount of insurance which could be collected, was $1,300. . . .

The question for decision is whether or not the phrase "other casualty" in [§165(c)(3)] can be construed so as to cover the loss of jewelry under the foregoing agreed statement of facts. . . .

Generally, the words "other" and "any other" following an enumeration of particular classes of things in a statute, must be read as meaning "other such like" and include only words of like kind or character. . . .

The word "casualty" has been defined as follows:

> An accident or casualty, according to common understanding, proceeds from an unknown cause or is an unusual effect of a known cause. Either may be properly said to occur by chance and unexpectedly. Chicago, St. Louis & N.O.R. Co. v. Pullman Co., 139 U.S. 79.

See also, Alice P. Bachofen Von Echt, 21 B.T.A. 702, 709. "Casualty" has also been defined as "an event due to some sudden, unexpected, or unusual cause," Matheson, Exec. v. Comm., 2 Cir., 54 F.2d 537, 539; and embraces losses arising through the action of natural physical forces and which occur suddenly, unexpectedly, and without design on the part of the one who suffers the loss. However, it is now recognized that a human agency can constitute or cause the sudden turn of events resulting in the loss. Ray Durden et al., 3 T.C. 1; Robert L. Stephens v. Commissioner, 3 T.C. 1.

The words "other casualty" were added by the 1916 Act, and the Treasury at first took the view that "other casualty" must be an incident similar to fires, storms or shipwreck arising from a natural cause and not due to negligence. In Shearer v. Anderson, 2 Cir., 16 F.2d 995, 996, this construction was held to be erroneous and the court, in allowing a deduction for damage to the taxpayer's pleasure automobile sustained when it overturned on an icy road, stated: ". . . as 'casualty' expresses rather the result than the cause of the damage, that is, the wreck itself rather than the lightning, storm, or the negligence or fault of some person, so the 'other casualty' is at least as clearly ejusdem generis (of the same kind) with shipwreck as with fire or storm." The court's modification of the Treasury Regulations in the case of Shearer v. Anderson, 2 Cir., 16 F.2d 995, does not change the Treasury's construction that the phrase means *or other like casualty,* because the court, in allowing a deduction for the damages resulting from the automobile wreck, held that the wreck of the automobile was similar to a shipwreck and was a casualty of the same kind.

Some of the losses which have been held to be deductible as from "other casu-

alty" are as follows: loss occasioned by freezing and bursting of water pipes in a residence during the absence of the occupant; loss occasioned by the bursting of a boiler used in heating a taxpayer's residence; damage to a factory from an earthquake; an extensive deep sinking of land caused by a subterranean disturbance; damage to trees caused by a sleet and ice storm; loss from violent quarry blasting operations.

Examples of losses that have been held not to be from "other casualty" are as follows: damage to buildings caused by termites; loss of a ring when there was no evidence or testimony establishing that the ring was stolen rather than mislaid, and the taxpayer did not attempt to establish the fair market value of the ring as of the date of disappearance; loss of a ring when it slipped from taxpayer's finger and was lost in muddy water when he was trying to retrieve a decoy while duck hunting; damage to a residence caused by excavations on property adjoining that of the taxpayer; loss occasioned by rusting and corrosion of the re-enforcing steel used in the cement floor beams of a house built on an island; damage on account of injuries caused to one who trips over a wire stretched in front of the taxpayer's residence; loss of household goods either in storage or in transit; and loss of a bird dog which disappeared when released for exercise by its handler and was never seen again. . . .

The case nearest in point is Stevens v. Commissioner, ¶47,191 P-H Memo T.C., where the taxpayer, while duck hunting and in the act of retrieving a decoy, a ring belonging to him, slipped off his finger and dropped into muddy water several feet deep. Although he was conscious of the fact at the moment the ring slipped from his finger, it disappeared into the muddy water making all efforts to recover it futile. In this case the Tax Court disallowed the deduction and said:

> The loss here was not like that resulting from the collision of an automobile, Shearer v. Anderson, supra; W. S. Bronson, 9 B.T.A. 1008; or a flood, Ferguson v. Commissioner, 10 Cir., 59 F.2d 893; or an ice storm, Frederick H. Nash, 22 B.T.A. 482; or subterranean disturbances, Harry Johnston Grant, 30 B.T.A. 1028. The petitioner merely permitted his ring to drop from his finger, by his own carelessness, we must presume, without the intervention of any sudden or destructive force. It was much the same kind of loss as might result from the loss of one's purse, or any other article of value. Certainly, if Congress had intended to allow the deduction of such losses it would have expressed its aim in language much simpler and more appropriate to that end than is to be found in [§165(c)(3)].

In the instant case it may be conceded that the loss of the rings was due to an unexpected and unusual cause and was not an intentional act on the taxpayer's part, but the loss lacks the element of suddenness. The primary cause of the loss was the placing of the rings in the kleenex tissue. The loss was caused by a chain of events on the part of Mrs. Keenan and Mr. Keenan. There was no intervening sudden force, cause or occurrence which brought on the event such as would ever be present in a casualty arising from fires, storms or shipwreck. I cannot say that the event or accident resulting in the loss was of the same kind as would be caused by fire, storm or shipwreck.

Therefore, judgment must be entered for the defendant, and it is so ordered.

NOTE

1. *Meaning of "casualty."* If the rings had been left in the hotel room when the taxpayers departed, and could not be found by the management when the taxpayers inquired about them a day later, would the loss be deductible? See Jones v. Commissioner, 24 T.C. 525 (1955). What if the rings had been left on a window sill and had been damaged or lost on being accidentally brushed off by a maid? Can the damage to the taxpayer's

own automobile in a collision or upset be deducted if he was driving negligently? Regs. §1.165-7(a)(3).

Does §165(c) allow the taxpayer to deduct the damage done by one snowstorm but not the damage done by a cold winter? If so, why? In ruling that a drought might be a "casualty," the Internal Revenue Service has said:

> Court decisions and Internal Revenue Service rulings . . . have developed the over-all concept that the term "casualty" . . . refers to an identifiable event of a sudden, unexpected, or unusual nature. . . . Under this concept, an identifiable event which would give rise to a casualty loss is not necessarily limited to an event of a sudden nature such as a flood, hurricane or earthquake, since it can also be of an unexpected or unusual nature. Thus, in the case of an unprecedented and unusual drought in an area which normally does not have prolonged and continued dry spells, a drought of such nature would be both unexpected and unusual and, therefore, would meet the above-mentioned test of an identifiable event. . . . On the other hand, a dry spell which is normal and usual in the particular area involved, would not meet the test indicated above since a drought of that nature would be neither "unexpected or unusual" for such area. Any loss resulting under such circumstances would be attributable to progressive deterioration of the property through a steadily operating cause and therefore would not constitute a "casualty" loss. [Special Ruling addressed to Senator T. C. Hennings, Jr., printed in 1954 P-H Federal Tax Service ¶76,570; see also Rev. Rul. 54-85, 1954-1 C.B. 58; Maurer v. United States, 178 F. Supp. 223 (D. Kan. 1959), rev'd on another ground, 284 F.2d 122 (10th Cir. 1960).]

Among the many misfortunes for which §165(c)(3) has been held to provide no balm are these: Scholhoff v. Commissioner, ¶63,213 P-H Memo T.C. (taxpayer paid $8800 to a dancing studio on implied representation he could "date" the instructors; held, no casualty loss even though he made no dates); Vance v. Commissioner, 36 T.C. 547 (1961) (taxpayer's household furniture was repossessed by finance company when his ex-wife failed to keep up the payments, and she wrongfully took certain fixtures from his house on her departure; held, neither event was a casualty); Powers v. Commissioner, 36 T.C. 1191 (1961) (taxpayer's Volkswagen was confiscated, 3 days after purchase, by East German authorities; held, a despotic act but not a casualty); Smith v. Commissioner, 10 T.C. 701 (1948) (taxpayer's thoroughbred bird dog disappeared; although court had "never seen [a photograph of] a more beautiful and intelligent looking dog" and believed "he would be a tempting prize for someone who was criminal-minded enough to steal a fine dog," mere disappearance is not sufficient evidence of theft; held, no deduction); Dyer v. Commissioner, ¶61,141 P-H Memo T.C. (taxpayer's cat broke a vase; taxpayer claimed that loss was attributable to cat's neurotic behavior, viz., a fit, rather than to her "ordinary perambulations"; held, not a casualty); Rev. Rul. 55-327, 1955-1 C.B. 25 (damage to fur coat by moths not deductible).

2. *Amount deductible.* Section 165(b) provides that the basis "for determining the amount of any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property." Section 1011, in turn, provides that the property's adjusted basis is to be determined by starting with its unadjusted basis (e.g., cost in the case of property purchased by the taxpayer; the date-of-death value in the case of inherited property), and then making the adjustments prescribed by §1016 (e.g., adding the cost of improvements and betterments, deducting depreciation if the property is depreciable business property, etc.). In Helvering v. Owens, 305 U.S. 468 (1939), the Supreme Court was called upon to apply these provisions to a taxpayer whose automobile, used for pleasure only, had been damaged in a collision. Its cost when new was $1825, its fair market value before the collision was $225, and its value after the collision was $190. The taxpayer claimed a deduction of $1635 — the difference between the car's cost and its value after the collision — arguing that its adjusted basis was $1825 because no depreciation is allowable on a pleasure car and that §165(b) requires the use of adjusted basis in determining the amount of the deduction. The Court of Appeals for the Second Circuit thought that this result was so obviously required by the language of the statute that "we should have to disregard the words, and should not be interpreting them, if we refused to take them just as they read." The Supreme Court reversed, holding

that the proper deduction was $35 (the difference between the property's value before the accident and its value immediately thereafter):

> As the income tax laws call for accounting on an annual basis; as they provide for deductions for "losses sustained during the taxable year"; as the taxpayer is not allowed annual deductions for depreciation of non-business property; as section [165(b)] requires that the deduction shall be on "the adjusted basis provided in section [1011]," thus contemplating an adjustment of value consequent on depreciation; and as the property involved was subject to depreciation and of less value in the taxable year, than its original cost, we think [§1016(a)(2)] must be read as a limitation upon the amount of the deduction so that it may not exceed cost, and in the case of depreciable nonbusiness property may not exceed the amount of the loss actually sustained in the taxable year, measured by the then depreciated value of the property. [305 U.S. at 471.]

Does this mean merely that the "loss sustained during the taxable year," within the meaning of §165(a), is the loss in value attributable to the accident — the rest of the decline in value being attributable to the taxpayer's use of the property in prior years? Since the loss on a *sale* of property that is dedicated to personal use cannot be deducted (supra p. 163), does such property lack an adjusted basis "for determining . . . loss" with the result that §165(b) has no relevance in determining the amount of the casualty loss allowable with respect to such property?

If by reason of inflation property damaged by casualty is worth, even after the accident, more than its cost, has the taxpayer suffered a "loss"? Suppose an imported camera purchased by the taxpayer for $150 is stolen from him when it is still as good as new. What is the amount of his loss if he is able to replace it for $100 because (a) its regular retail price has declined, (b) he happens to be in the country of manufacture and need not pay the United States duty, or (c) his uncle's brother-in-law gets one for him wholesale? If in any of these circumstances his loss is limited to $100, would it matter that instead of replacing the camera he decided to do without? What if when the camera was stolen from the taxpayer its value because of wear and tear was $100, but because the taxpayer was on an expedition and had immediate need for a camera, he was compelled to have a replacement shipped to him by chartered plane? What is the deduction if when the camera is stolen its "fair market value" is $100 if sold by a store but only $75 if offered for sale by a private individual?

For the conditions under which the cost of repairs may be used to establish the loss of value suffered by the taxpayer, see Regs. §1.165-7(a)(2)(ii).

After a struggle, the Treasury has agreed that a casualty loss on business property is to be computed in the same way as a loss of non-business property, except that if business property is totally destroyed, the taxpayer may deduct its pre-accident adjusted basis if it exceeds the pre-accident fair market value. Regs. §1.165-7(b)(1); Alcoma Assn., Inc. v. United States, 239 F.2d 365 (5th Cir. 1956). Why this residual difference between business and non-business property?

3. *The $100 deductible "floor."* By virtue of a 1964 amendment to §165(c)(3), non-business casualty losses are deductible only to the extent that they exceed $100 per casualty.

4. *When is the "loss" sustained?* Sometimes the amount of a loss caused by storm or similar casualty is not known in the year of the catastrophe, either because the extent of the damage is not immediately ascertainable or because the taxpayer does not yet know how fully he will be compensated by insurance. In several cases, the loss has been held deductible when finally measured. Barret v. United States, 202 F.2d 804 (5th Cir. 1953); Commissioner v. Harwick, 184 F.2d 835 (5th Cir. 1950).

Ascertaining the date of a loss resulting from embezzlement by an employee is sometimes especially difficult, because the pilferage may not be discovered until years after it occurred; indeed, the taxpayer may even be unable to determine who was responsible or when the funds were taken. Under pre-1954 law, the Regulations provided that a loss from theft or embezzlement was "ordinarily" deductible for the year in which it was "sustained." Saying that "ordinarily does not mean always," the Supreme Court allowed a taxpayer to deduct his loss in the year the embezzlement was discovered where he was

unable, despite a painstaking investigation, to establish either the identity of the embezzler or the years of the defalcations, and held that a deduction in the year of discovery was also proper for a taxpayer whose discovery of the embezzlement came after the statute of limitations had run on filing amended returns for some of the years in which the funds had been taken. Alison v. United States, 344 U.S. 167 (1952). Without indicating what was unsatisfactory about this flexible approach, except that it was uncertain, in 1954 Congress enacted §165(e) to provide that a loss arising from "theft" (which according to the Senate Report on the 1954 Code, p. 198, includes "embezzlement, larceny, etc.") shall be "treated as sustained during the taxable year in which the taxpayer discovers such loss." Does a taxpayer "discover" a "loss" when he finds that an employee took money from the cash register or only when he finds that the employee is unable to pay it back? In order to claim the deduction, must the taxpayer show that the embezzled funds cannot be recovered from the employee? G. M. Still, Inc. v. Commissioner, 218 F.2d 639 (2d Cir. 1955). If the employer decides not to press the embezzler for payment because this would — for example — require a foreclosure of his home, has the employer sustained a loss? If the embezzler gives the taxpayer a promissory note equal to the amount he has taken, and the taxpayer refrains from pressing a complaint against him, what are the tax consequences to the taxpayer? To the embezzler? See *James*, supra page 110.

Section 165(h), enacted in 1962, permits a "disaster" loss (if occurring within a qualified geographical area) to be deducted, at the taxpayer's election, in the taxable year before its occurrence. Why?

5. *Adjustment to basis.* Assume that Jones pays $2000 for an automobile and that when it is damaged in a collision he takes a (properly computed) $500 casualty loss deduction. Thereafter he spends $200 to repair part of the damage and, because of an inflation in automobile prices, sells the car the next year for $2300. What is his profit on the sale? Does the answer depend on whether the casualty deduction produced a tax benefit?

5. *References.* Caplin, Casualty Losses: Recent Developments, 12 N.Y.U. Inst. on Fed. Taxation 525 (1954); Deming, Establishing Casualty and Disaster Losses, 21 N.Y.U. Inst. on Fed. Taxation 143 (1963).

ALSOP v. COMMISSIONER

290 F.2d 726 (2d Cir. 1961)

Before MEDINA, MOORE and FRIENDLY, Circuit Judges.

FRIENDLY, Circuit Judge.

Petitioner is a well-known author, residing in Connecticut. She kept her records and filed her tax returns on a cash basis. She had a literary agent, named — somewhat inappropriately as things turned out — Rowe Wright. From January 1, 1942 to June 6, 1952, Rowe Wright received royalties aggregating $65,623.58 for petitioner's account from various foreign publishers. In five of the years Wright reported and remitted nothing to petitioner; in the other six she reported and remitted sums aggregating $8,580.88. The balance, $57,042.00, she embezzled, without petitioner having known the payments had been received. None of the royalties so unreported and embezzled were ever returned by petitioner as taxable income.

In 1952, petitioner discovered that certain foreign royalties due her had not been received. She dismissed Wright and obtained a judgment against her for $46,962.98, representing embezzled royalties paid by an English firm. In 1953, petitioner obtained a second judgment for $10,079.72 against Wright; this represented royalties from publishers on the Continent that Wright had embezzled.

In petitioner's return for 1952, she deducted the 1952 judgment as a "Loss due to embezzlement and defalcation of funds by agent"; this resulted in a net loss for the year. In her 1953 return, as amended, she deducted the 1953 judgment, as well as a net operating loss carry-over from 1952. In her amended return for 1954, she claimed a further deduction of the net operating loss carry-over.

In 1954, petitioner recovered $10,879.54 on account of the judgments. She did not include this as 1954 income.

The Commissioner issued a notice of deficiencies for 1952, 1953 and 1954. He disallowed the amounts claimed as embezzlement losses and the net operating loss carry-overs resulting therefrom, as well as a carry-back claimed for 1951 not directly here in issue. He also determined that the amount received by petitioner in 1954 in partial satisfaction of the judgments was taxable income of that year. . . .

. . . Petitioner was on a cash receipts and disbursements basis. Section [165] can hardly be read as permitting a deduction for the deprivation of income taxpayer has not received. . . .

Normally, indeed, "receipt of income by an agent is equivalent to receipt by the principal and such income is either actually or constructively received by him," 2 Mertens, Law of Federal Income Taxation (1955), p. 19; Maryland Casualty Co. v. United States, 1920, 251 U.S. 342, 345. But this rule can hardly apply where the agent of a cash basis taxpayer spirits away income of whose receipt the taxpayer never knew. Cf. Stoumen v. C.I.R., 3 Cir., 1953, 208 F.2d 903, 906; Ismert-Hincke Milling Co. v. United States, 10 Cir., 1957, 246 F.2d 754. What Rowe Wright did was to transform taxpayer's accounts receivable from the publishers into a claim in tort against the agent. That this was an economic loss to taxpayer is undeniable; but it was not the kind of loss that would appear in a cash receipts and disbursements system of income accounting.

Alison v. United States, [344 U.S. 167], does not fill the gap. There no one denied a loss had been sustained; the only question was whether it could be taken in the year of discovery as the Court held, or only in the year of occurrence as a more literal reading of the statute would have demanded.* The record in one of the two cases there decided, Stevenson-Chislett, Inc. v. United States, D.C.W.D. Pa. 1951, 98 F. Supp. 252, shows that the embezzling employee had made proper entries of receipts of income in the accounts, which, at least inferentially, had been reported, only the piracy being hidden. The facts in Mrs. Alison's case, D.C.W.D. Pa. 1951, 97 F. Supp. 959, are somewhat less clear. The thefts included, and presumably consisted predominantly of, principal; if any of them were of income for which the agent had never accounted, the record does not show this and the parties did not question, either in the District Court or in the Supreme Court, that taxpayer had suffered a loss. We find it difficult to believe the Supreme Court would have sanctioned a liberalizing of the statutory language as to the year when a theft loss is to be taken so as "to prevent hardships and injustice," 344 U.S. at page 169, in order to provide a deduction for theft of income of whose existence the taxpayer had never known and which she had never reported.

With respect to the $10,879.54 recovered in 1954, taxpayer's argument is that this represented income of the years when the royalties were received and is excluded from 1954 income under §111 of the 1954 Code, providing that "Gross income does not include income attributable to the recovery during the taxable year of a bad debt, prior tax, or delinquency amount, to the extent of the amount of the recovery exclusion with respect to such debt, tax or amount" since, if the embezzlement losses are disallowed, the recovery would come within the definition of "recovery exclusion" in [§111(b)(4)]. If the first step in taxpayer's argument were correct, the second would follow; but it is not. These payments constitute 1954 income not because they are attributable to a "recovery" but be-

* As stated in paragraph 4 of the preceding Editor's Note, §165 was amended after the *Alison* case by the addition of §165(e). — Ed.

cause they became income to this cash basis taxpayer in 1954 for the first time.
Affirmed.

NOTE

If the taxpayer had known of the royalties but had inadvertently failed to report them, would a loss by embezzlement of the funds be deductible? What if an automobile purchased with unreported income is damaged by fire or collision?

7. Bad Debts

Section 23(k) of the 1939 Code, dealing with bad debts, was carried over, with some changes, by §§166 and 165(g) of the 1954 Code.

SMYTH v. BARNESON

181 F.2d 143 (9th Cir. 1950)

Before: STEPHENS, HEALY and POPE, Circuit Judges.

STEPHENS, Circuit Judge.

The Collector of Internal Revenue is appealing from a judgment of the district court decreeing a refund to a taxpayer. The controversy arises out of the disallowance by the Commissioner of Internal Revenue of a $150,000 bad debt deduction taken by appellee on her 1941 individual federal income tax return.

The case comes to us upon stipulation of facts supplemented by the testimony of one witness for appellee and one, an Internal Revenue agent, for the Collector. The refund was decreed upon the finding that the questioned debt existed on January 1, 1941, and was then of value and that it became worthless during the ensuing year. Internal Revenue Code [§166 (a)(1)].

The Collector thinks the alleged debt never existed but that if it ever existed the sum of the loss cannot be taken as a bad debt deduction because the taxpayer failed to take reasonable steps to collect it.

In order to rule with appellant Collector as to the non-existence of the debt, we must determine that the court's contrary finding was clearly erroneous. In determining this point we consider all of the evidence giving the written evidence the weight we deem it entitled to de novo and applying the oral evidence with "due regard . . . to the opportunity of the trial court to judge of the credibility of the witnesses." Rule 52(a), Federal Rules of Civil Procedure.

The facts, in brief, are: In 1928 and 1929 the taxpayer advanced to her father $150,000. He used the money, and a like amount secured from his wife, taxpayer's mother, together with some of his own personal funds, to invest in a brokerage firm. The amounts so advanced were entered in the father's books in individual loan accounts. Yearly returns from such investment were received by the father up until 1932, and divided by him with his wife and daughter in the ratio of their advancements to him. On taxpayer's tax returns for the years thus involved, such monies as she received from her father were reported as income from partnership except for one year in which it was reported as interest. In 1932 the firm failed, and the father took on his tax return for that year a loss for the total amount invested although he derived no tax benefit therefrom. Taxpayer had income tax liability for that year which would have been eliminated if she had taken as a loss the amount advanced to her father. Thereafter, the father paid nothing to taxpayer. Taxpayer was adjudged incompetent in 1936 and a brother was appointed her guardian. Shortly thereafter in 1936 the mother died and the brother was appointed executor of the mother's estate. In the same year

the father voluntarily informed the executor that he owed his deceased wife $150,000 and that he owed a like amount to taxpayer, and that he intended to pay both debts. The $150,000 thus stated by the father to be owing to his deceased wife he paid to her estate in 1937, and the loan account as to her on his books was closed out. The father died in 1941, and a claim for the $150,000 filed against his estate by taxpayer's guardian was rejected in 1941 as being barred by the statute of limitations. The father, at all material times, was financially able to pay such amount to the taxpayer. The alleged debt was never listed as an asset on any of the inventories filed with any court by taxpayer's guardian. No note or other evidence ever indicated an obligation on the part of taxpayer's father to repay to her the $150,000.

All the above facts were stipulated to except for the testimony of taxpayer's brother, her guardian, as to the conversation had with the father in 1936 in which the latter stated that he owed taxpayer $150,000.

If the trial court assumed, which it evidently did, that taxpayer's guardian spoke the truth, the father's declaration against interest as to his indebtedness to his daughter was amply sufficient to sustain the finding that the debt was existent at the time. Upon the whole record, we hold that the trial court's finding was not clearly erroneous. Compare Orvis v. Higgins, 2 Cir., 180 F.2d 537.

As a basis for argument only and after making it plain that he believes the alleged debt never existed, the Collector assumes that the debt did exist and that it became worthless in 1941. He then contends that the "taxpayer is nevertheless not entitled to a bad debt deduction . . . unless she had made a reasonable effort to collect the debt." This she did not do.

Section [166(a)(1)] of the Internal Revenue Code authorizes a deduction for "any debt which becomes worthless within the taxable year." [1] The statute requires, as the basis for a deduction, that a debt actually existed and that it became worthless within the taxable year in which the deduction is claimed. Appellant would have us add a third requisite, i.e., that a reasonable effort must have been made to collect the debt.

It is true that the evidence as to efforts to collect is relevant as to the time a debt actually becomes worthless but, by and of itself, effort to collect is not an element of worthlessness. Authorities cited by the Collector do not hold contrariwise. In the instant case the death of taxpayer's father and the rejection of her claim against his estate in 1941 established its noncollectibility and therefore worthlessness. This fact alone is not conclusive of when it became noncollectible or worthless. But the trial court after consideration of all the evidence was of the opinion that the debt existed and that it might well have been paid at any time before the father's death. Notwithstanding the fact that the statute of limitations could have been pleaded as a complete bar prior to 1941, the debt was existent and at any time might have been paid voluntarily by the debtor [he paid $150,000 into his wife's estate] and could have been collected through court action up to the moment of the debtor's death, except for a special plea setting up the statute of limitations in bar. After the debtor's death, the law, California Probate Code, §708, prevented the payment of any debt as to which the statute of limitations had run. . . .

Affirmed.

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[1] [Section 23(k)(1), 1939 Code] as in effect in 1941 authorized a deduction for "Debts *ascertained* to be worthless and charged off within the taxable year. . . ." By the Revenue Act of 1942, §124(a) and (d), 56 Stat. 820, 822, this section was amended to read "Debts which *become* worthless within the taxable year . . ." and as amended was made applicable retroactively to taxable years beginning after December 31, 1938.

NOTE

1. *Intra-family loans.* Whether an intra-family transaction is a gift or a loan is frequently litigated; the Tax Court has said that transfers from husband to wife are presumed, though not irrebutably, to be gifts. Van Anda v. Commissioner, 12 T.C. 1158 (1949), aff'd per curiam, 192 F.2d 391 (2d Cir. 1951). Section 166(d), which came into the Code in 1942, provides that "non-business" bad debts give rise to capital loss rather than to ordinary loss. The significance of this provision is made clear in Chapter 6, but it may be noted here that capital losses are of restricted deductibility. Section 166(d) will apply to many intra-family transactions, but it embraces other non-business debts as well.

2. *Loans to political organizations.* In 1952, Congress enacted §271, providing that uncollectible loans to political organizations shall not be deductible, except by banks. Political *contributions* are not deductible (why not?), and §271 puts *loans*, which might be used as disguised contributions, on a par with contributions.

3. *Date debt becomes bad.* As the footnote in the principal case indicates, the statute formerly permitted the deduction only if the debt was "ascertained to be worthless and charged off within the taxable year." If the taxpayer kept no books, a "mental charge-off" might do. Where books were kept, however, it was possible that the deduction would be lost altogether. For the debt might become worthless in one year but (because of unwarranted optimism) the taxpayer's ascertainment of worthlessness and charge-off might have occurred in a later year. Then the year of charge-off would be incorrect, while the earlier year of actual worthlessness could not be used because in it there was no ascertainment of worthlessness and charge-off. Since 1942 the statute has provided that the deduction shall be taken for the year of worthlessness, objectively determined. The selection of the proper year is still something of a guessing game, but since 1942 the taxpayer has been allowed seven years for claiming a refund based on a bad debt, instead of the usual three years. §6511(d)(1). Thus if he finds that he was unduly optimistic in waiting until a given year to take the deduction, he will ordinarily be able to file a refund claim for an earlier year without being met by a statute of limitations defense. See also §1311, infra pages 877-879.

4. *Business bad debts.* Business bad debts are taken up infra pages 285 et seq.

SECTION C. PERSONAL AND DEPENDENCY EXEMPTIONS

By §151, the taxpayer is allowed a $600 personal exemption for himself and, if he files a joint return with his wife, a $600 exemption for her. An additional exemption of $600 is allowed if either of them is blind or has attained the age of 65 before the end of the taxable year. These exemptions are cumulative, i.e., if *both* the taxpayer *and* his wife are 65 or over *and* blind, they are entitled to 6 personal exemptions, for a total of $3600.

Section 151 also provides an exemption of $600 for each qualified dependent of the taxpayer. To qualify, the person must (1) be related to the taxpayer by blood, marriage, or adoption within the degrees specified by §151(a)(1)-(8) or meet the special requirements of §151(a)(9) or (10); (2) derive more than one half of his support from the taxpayer; and (3) have a gross income of less than $600 for the year in which dependency is claimed. The gross income restriction is inapplicable, however, if the dependent is the taxpayer's child, is either under the age of 19 or a student, and (if married) does not file a joint return with his spouse.

The rationale of these exemptions and the legal problems that they create are discussed infra pages 337 et seq.

SECTION D. CREDITS AGAINST TAX

After the tax has been computed, it is reduced by certain credits. The most important is the credit for taxes withheld from wages. §31. Any amounts paid

as "estimated tax" (supra p. 20) are also credited against the tax liability reported on the return, though these amounts are, strictly speaking, not credits but payments on account of the tax itself. If the taxpayer had any partially tax-exempt interest, he is allowed a credit of 3 per cent thereof. §35; supra page 161. Taxes paid to foreign countries and possessions of the United States are also allowed, to a limited extent, as credits against the federal income tax. See §§33 and 901.

Section 37 of the 1954 Code introduced a new credit for "retirement income." A qualified taxpayer may credit against his tax liability 17 per cent (15 per cent in 1965 and later years) of his "retirement income" (pensions, annuities, interest, rents, and dividends). To qualify, the individual must be over 65 (except that pensions and annuities under a public retirement system qualify even though the recipient is under 65); and he must have received "earned income" in excess of $600 in each of any ten earlier years. In computing the credit, not more than $1,524 of retirement income ($2,286 for certain married persons) is taken into account, and even this amount must be reduced by any tax-free pensions or annuities (such as social security benefits) and, in some cases, by any earned income over specified amounts in the taxable year. The announced purpose of the credit (S. Rept. 8) was to adjust the differential that previously existed between persons who receive federal social security benefits, which have always been tax exempt, and those who receive taxable pensions or who have provided independently for old age. The parallel to social security is responsible for the 10-year earned income qualification and for the reduction of retirement income by earned income in certain circumstances, as well as for the 65-year age requirement.

The 1954 Code also introduced a 4 per cent credit for dividends received by individual taxpayers, which was reduced in 1964 to 2 per cent for 1964 dividends and eliminated for 1965 and later years. See infra pages 604-606.

CHAPTER 3

The Business Taxpayer

SECTION A. GROSS INCOME

The determination of a business taxpayer's gross income is not radically different from determining the gross income of a non-business taxpayer. The exclusions (gifts, bequests, life insurance proceeds, etc.) already examined for the non-business taxpayer are equally available to the taxpayer engaged in business, although the nature of some of the exclusions means that they will ordinarily be of principal interest to non-business taxpayers. This is especially true of bequests and annuities. Gifts to business corporations (or to individuals in their business rather than personal capacity) are also uncommon, of course, though there are a few cases dealing with subsidies by municipalities and other government agencies to attract or encourage local business. Brown Shoe Co. v. Commissioner, 339 U.S. 583 (1950); see United States v. Maryland Jockey Club, 210 F.2d 367 (4th Cir. 1954), cert. denied, 347 U.S. 1014; Freeman and Speiller, Tax Consequences of Subsidies to Induce Business Location, 9 Tax L. Rev. 255 (1954); Note, Tax Consequences of Non-shareholder Contributions to Corporate Capital, 66 Yale L.J. 1085 (1957); §118 (contributions to corporate capital not includible in gross income); §621 (certain federal subsidies not includible in gross income).

Perhaps the most striking difference between the business and the non-business taxpayer in calculating gross income lies in accounting methods. Non-business income is almost always reported on the cash receipts and disbursements basis — that is, income is reported only as cash or its equivalent is received, and deductions are taken as the taxpayer pays his debts with cash or property. On the other hand, the gross income of a business (whether carried on by an individual, a partnership, or a corporation) is often calculated on the accrual basis: income is reported as the customers are charged for goods or services rather than when they pay, and expenses are deducted as obligations are incurred, even though payment is postponed. Moreover, if the business enterprise's inventory is significant in size, account must be taken of the goods on hand at the beginning and at the end of the taxable year in ascertaining gross income, and income must ordinarily be computed on the accrual method. §471; Regs. §1.446-1(c)(2)(i). The use of inventories has the effect of charging the cost (or other valuation) of goods that are sold against income in the year in which they are disposed of, rather than in the year when they were purchased or manufactured. Both the cash and accrual methods of computing income and the use of inventories are examined in more detail in Chapter 9.

SECTION B. DEDUCTIONS

In Chapter 2 we saw that the taxpayer has been authorized by Congress to deduct certain of his expenses whether they were incurred in the pursuit of income or not. Thus the taxpayer can deduct medical expenses, charitable contributions, interest, taxes, and bad debts, for example, even when they are exclusively personal expenses. But most personal expenses — food, clothing, and shelter; wine, women, and song — are not deductible.

Now we turn to an area in which Congress has chosen to allow the deduction of substantially all expenses: those incurred in the taxpayer's trade or business or in his profit-seeking transactions. Unlike the cost of living, then, the cost of *earning* a living is ordinarily fully deductible. If Congress had chosen instead to deny or narrowly restrict the deductibility of *business* expenses, it would have imposed a sales or gross receipts tax rather than an income tax. This would have been constitutional, supra page 8n, but its impact would have been very different from the income tax. What we do have is an income — more exactly, a *net* income — tax.

The statutory framework for allowing the cost of making a living to be deducted consists primarily of these three provisions:

(1) Section 162(a), authorizing the deduction of all the ordinary and necessary *expenses* paid or incurred during the taxable year in carrying on any trade or business.*

(2) Section 212, authorizing, in the case of an individual, the deduction of all the ordinary and necessary *expenses* paid or incurred during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income. These are commonly referred to as "nonbusiness expenses," but this term is misleading: it means not that these expenses are personal living expenses, but only that they result from profit-oriented transactions that do not constitute the carrying on of a "trade or business" under §162(a).

(3) Section 165(a), authorizing the deduction of any *losses* sustained during the taxable year and not compensated for by insurance or otherwise. In the case of an individual, §165(c)(1) and (2) restrict the deduction of losses to those incurred in trade or business or in a transaction entered into for profit. Section 165(c) also permits the deduction of casualty losses, even though unconnected with trade or business or transactions for profit. Supra page 192.

These statutory provisions, and others that are less fundamental, are examined in this chapter.

A historical note may first be in order.

Section 212 — allowing an individual (including trusts, estates, and partners) to deduct the expenses of producing or collecting income or of managing, conserving, or maintaining property held for the production of income — was enacted in 1942. Previously, §23(a) of the 1939 Code (the predecessor of §162(a) of the 1954 Code) had permitted only the expenses of "carrying on any trade or business" to be deducted. In 1941, the Supreme Court upheld a decision of the Board of Tax Appeals that this phrase was not broad enough to cover the expenses of a wealthy investor who lived in Paris but maintained an office and staff in New York City (at an expense of $16,000 in one year and $20,000 in another)

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* Since §162(a) allows the taxpayer to deduct "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business," it partially overlaps several provisions that authorize items to be deducted whether they are incurred in the taxpayer's business or not, e.g., §163 (interest) and §164 (certain taxes). Ordinarily it makes no difference whether a deduction is supported by reference to the specific provision or by reference to the more general language of §162(a). (In any event, the same item may not be deducted twice.) For some purposes, however, a taxpayer is required to treat his business expenses differently from other deductions; thus, in determining whether a corporation is a "personal holding company," the gross amount of "the deductions allowable under section 162" is relevant. In general, the courts have held that interest, taxes, etc. may constitute business expenses under §162 even though they also qualify for deduction under other provisions. McNutt-Boyce Co. v. Commissioner, 38 T.C. 462 (1962), and cases there cited. This case was affirmed per curiam, 324 F.2d 957 (5th Cir. 1963).

The fact that §162(a) may partially overlap these specific provisions should not be allowed to obscure the fact that §162 is sometimes broader in its scope: thus, taxes that do not come within §164 may be deducted under §162(a) if they meet its requirements.

to manage under his own direction his investments in stocks and bonds. Higgins v. Commissioner, 312 U.S. 212 (1941). Section 23(e)(2) of the 1939 Code (see §165(c)(2) of the 1954 Code), however, had for many years allowed an individual to deduct *losses* incurred "in any transaction entered into for profit," even though not connected with a trade or business. Higgins, then, could have deducted any *loss* on the sale of his securities, even though he could not deduct the *expense* of investment advice, safe-deposit rental, and bookkeeping service related to the same securities. Moreover, it was admitted by the Treasury that Higgins' *real estate* activities *did* constitute a trade or business, so that the expenses of those activities were deductible, and some cases have since held that ownership of any rental property constitutes a trade or business, no matter what the taxpayer's main occupation is. Infra p. 551. Since only the *net* income from renting real estate was taxable, it was not surprising that Congress decided to tax only the *net* income from investing (or speculating) in stocks or bonds or from other profit-seeking activities. Section 212 was the result.

Section 212 applies only "in the case of an individual." A similar statutory change was not required for corporations, since corporate expenses for the production or collection of income or for the management, conservation, or maintenance of property held for the production of income were presumably already deductible as expenses of the corporation's trade or business. This is not to say that a corporation's expenses are necessarily deductible: they are not. A corporation may own property for the convenience of its stockholders rather than to make money. See, for example, Savarona Ship Corp. v. Commissioner, ¶42,596 P-H Memo T.C., involving a yacht, and Black Dome Corp. v. Commissioner, ¶46,130 P-H Memo T.C., involving a country estate. When the corporation's activities are profit-directed, however, §162(a) is broad enough to accomplish what it required both §162(a) and §212 to accomplish for individuals.

The issues that arise under §162(a), §165, and §212 — the principal business expense and loss sections — are considered in the pages that immediately follow. Thereafter, certain other business deductions are examined.

1. *Expenses and Losses Incurred in Business or Profit-seeking Activities*

Section 162(a), relating to trade and business expenses, corresponds to §23(a)(1)(A) of the 1939 Code.

Section 212(1) and (2), relating to an individual's expenses for the production of income, corresponds to §23(a)(2) of the 1939 Code. Section 212(3) was added in 1954.

Section 165(a) and (c), relating to losses, was derived from §§23(f), 23(e)(1), and 23(e)(2) of the 1939 Code.

Section 262, relating to personal, living, and family expenses, was formerly §24(a)(1) of the 1939 Code.

The issues that arise under these sections have been grouped together in the pages that follow under these heads:

(a) Was the expense or loss incurred in business or profit-seeking, on the one hand, or in the pursuit of pleasure, on the other?

(b) Did the taxpayer incur an expense or loss, or did he make a capital investment?

(c) Was the expense, if there was one, "ordinary and necessary"?

These compartments are not watertight, but they are satisfactory if one does not put too much pressure on them.

a. BUSINESS OR PLEASURE?

SMITH v. COMMISSIONER
9 T.C. 1150 (1947)

HILL, Judge: The question is whether petitioner operated the farm as a trade or business or for profit, on the one hand, or for recreational purposes or as a hobby, on the other. As is implicit or stated in the cases cited by both petitioner and respondent, the answer to this question lies in determining petitioner's intention from all of the evidence. We have concluded that the facts show that the petitioner's intent in operating the farm was primarily for the purpose of making a profit.

Respondent bases his argument that petitioner had no intent to operate the farm as a trade or business or for profit on the following points: (1) That the operation of the farm resulted in a series of uninterrupted losses, (2) that petitioner's purchase of the farm was essentially motivated by his desire to have a country estate for his home, and (3) that petitioner operated the farm in order to supply his family with food for home consumption.

It is true that the petitioner has experienced continuous annual losses from the operation of his farm since its acquisition in 1933 and through the taxable years in question. Moreover, the record discloses that after the taxable years involved here there were further losses in 1944, 1945, and 1946.* The fact that the operation of the farm has resulted in a series of losses, however, is not controlling if the other evidence shows there is a true intention of eventually making a profit. See Israel O. Blake, 38 B.T.A. 1457. Respondent cites the case of Thacher v. Lowe, 282 Fed. 944, to support his argument. The court in that case stated:

> . . . it is difficult to imagine how a farm which has been running the number of years which this had could be thought capable of turning a deficiency of 90 per cent into a profit.

On the facts in the instant case, however, we can not say that there is no reasonable expectation of realizing a profit.

We do not agree with the respondent that petitioner purchased the farm primarily to satisfy his desire to live on a country estate. It may be true that petitioner experienced pleasure from residing in a country home, but this fact alone does not negative his intent to operate the farm for profit. Wilson v. Eisner, 282 Fed. 38. Nor is such intent negatived by the fact assumed by respondent that petitioner, as a business executive, has received an annual salary sufficiently high to indicate no need to supplement his income by the farm operation.

We are convinced from the record that it has at all times been petitioner's intention to operate the farm for profit, and that he had reasonable expectations of accomplishing that result. His efforts to make a profit have included increasing the land in cultivation and in pasturage from 75 to 95 acres, renting the farm, employing an experienced farmer to operate it under his supervision, improving the land by reclamation practices and fertilization and soil conservation methods, and engaging at various times in a number of diversified types of farming. He spends most of his week ends working on the farm, performing such odd jobs as repairing buildings or equipment, feeding poultry, and spraying orchards. On week days he usually consults with his employee for 10 or 15 minutes each morn-

* For the years 1940 through 1946, the net losses ranged from about $390 to $2800 per year. The taxpayer's compensation as a business executive was $65,000 in 1942 and $74,000 in 1943. — ED.

ing in connection with problems related to the operation of the farm. In addition he has expended a great deal of money in repairing farm buildings and buying farm equipment, all of which was for utilitarian rather than beautification purposes. He has always considered the farm separate from his home, he has segregated the capital and operating expenses of the residence from the farm expenses, and he has not used the farm for any social or recreational purposes, nor does it have any such facilities.

This leaves for our consideration respondent's argument that petitioner operated the farm primarily for the purpose of providing wholesome food for his family. It should be noted, first, that petitioner and his family consumed at the most only 10 per cent of the farm products on the average and that all of those used were included and reported in the farm income at regular prices. The other approximately 90 per cent of the farm produce was sold by the petitioner to local butchers and grocerymen, to purchasers stopping by the farm, and occasionally to the Delaware Packing Co. at Trenton. In addition to that, the types of products raised by petitioner included poultry, eggs, cattle, sheep, wheat, corn and hay, many of which are not readily adaptable to home consumption, and such of them as were so adaptable were produced in far greater quantities than his home consumption requirements. The petitioner's primary intention, therefore, was not to produce good food for home consumption. Consequently, the case of Louise Cheney, 22 B.T.A. 672, cited by respondent, is not in point.

We hold that petitioner's farm operations during the taxable period here involved were a business regularly carried on by him for profit and that the losses in question resulted from ordinary and necessary expenses paid during such taxable period in carrying on such business and, therefore, are deductible for income tax purposes.

NOTE

1. *Tax treatment of hobbies.* If the court had found that the farm was operated as a hobby, would the expenses or only the net loss have been disallowed — was this a §162(a) or a §165(c) case? If §162(a) is controlling, could the expenses of a hobby farm be disallowed even though it was operated at a profit? See the last sentence of Regs. §1.162-12 (taxpayer may ignore both receipts and expenses of unsuccessful hobby farm), with which compare Regs. §1.212-1(c) (expenses of hobbies not deductible under §212, receipts not being mentioned).

In the principal case, the taxpayer reported as income the value, "at regular prices," of farm produce consumed at home. Assume that the cost of raising home-consumed produce is $1000, that the wholesale value of the produce is $600, and that the retail value is $900. How should the taxpayer account for the produce? What if the wholesale and retail values were $1200 and $1500 respectively?

2. *Results in litigated cases.* Commenting on the country estate and racing stable cases, Randolph Paul has said:

> The American businessman has never appeared so indefatigably optimistic as in some of the cases on this point; taxpayers have earnestly contended (sometimes successfully) that they expected to reap an ultimate profit even though operating losses exceeded receipts with depressing regularity over a long period of years. [Paul, Motive and Intent in Federal Tax Law, in Selected Studies in Federal Taxation 281-282 (Second Series, 1938).]

Horse breeding and racing, though the sport of kings, have been held in a surprising number of cases to be the business of taxpayers. See, for example, Commissioner v. Widener, 33 F.2d 833 (3d Cir. 1929) (losses of more than $300,000 in four years); Whitney v. Commissioner, 73 F.2d 589 (3d Cir. 1934); Farish v. Commissioner, 103 F.2d 63 (5th Cir.

1939). In the last case, the possibility of geographical and occupational discrimination was suggested:

> The intention of the taxpayer at the outset is the dominant factor in determining whether he engaged in the venture merely for pleasure or for profit. Of course, the Board could rest its decision on the circumstantial evidence, as opposed to the sworn testimony of the taxpayer. But we think the Board was psychologically wrong in concluding that the Farishes, as men of sound business judgment, would not have engaged in the ventures with any expectation of profit. Both are actively engaged in the oil business. It is common for a man in the oil business, of sound judgment, to expend thousands of dollars in exploring the land and drilling for oil in "wild cat" territory. Sometimes this results in dry holes and the costs of drilling and development are totally lost. On other occasions, producing wells are brought in and the profits are enormous. The breeding of horses would not be considered merely a fad in Texas. It is not at all improbable that men in the oil business, having ample capital, would engage in the enterprises here involved with the hope and expectation of ultimately making a fair return on the investment. [103 F.2d at 65.]

See also Ellsworth v. Commissioner, ¶62,032 P-H Memo T.C., in which the government relied on 13 years of uninterrupted losses aggregating almost $700,000 in the operation of a livestock breeding farm and on the taxpayer's scientific interest in cattle breeding as establishing that he was engaged in a hobby, not a business; despite the taxpayer's bravado in naming the enterprise "Folly Farm," it was held a business.

Gentlemen authors seem to lose money as regularly as gentlemen farmers, but have been less successful in proving their acquisitive intentions. Chaloner v. Helvering, 69 F.2d 571 (D.C. Cir. 1934); Purdy v. Commissioner, 12 T.C. 888 (1949); Lamont v. Commissioner, ¶64,002 P-H Memo TC; but see Vanderbilt v. Commissioner, ¶57,235 P-H Memo T.C. See also Ewing v. Commissioner, 213 F.2d 438 (2d Cir. 1954).

In Hempel v. Commissioner, ¶47,183 P-H Memo T.C., a formerly successful concert singer seeking to make a comback was held to be engaged in a trade or business although she claimed expenses of $10,000-$15,000 annually for 12 years with only nominal earnings; the Tax Court rejected the government's ungallant argument that the expenses were personal expenses to continue "the illusion of a famous prima donna who could not bear to slip out of the public eye."

What are the prospects for a collector of art, rare books, or postage stamps who claims a deduction under §165(c)(2) on the ground that though he enjoyed looking at his collection, his primary aim was to build up a hedge against inflation and eventually to sell at a profit?

See Howell v. Commissioner, 41 T.C. No. 2 (1963), in which the taxpayer's participation as a silent partner in a partnership engaged in the theatrical agency business was held to be a method of providing financial assistance to the other partner, the taxpayer's sister-in-law, rather than a trade or business or transaction entered into for profit.

3. *Section 270's restriction on the deductions of a consistently unprofitable business.* Even if the taxpayer succeeds in establishing that he is engaged in a trade or business, §270 denies him the right to deduct more than $50,000 per year from his other income (salary, interest, dividends, etc.) if the trade or business in question results in losses of $50,000 or more each year for 5 consecutive years. The statute of limitations is extended so as to permit the Commissioner to recompute the tax for earlier years after the trade or business has produced the required series of loss years.

By virtue of §270(b), enacted in 1954, a number of "specially treated" deductions are disregarded in determining whether the requisite losses have been incurred, primarily to protect farmers and mineral businesses from §270. If the taxpayer carries on two or more businesses, each must be examined separately in applying the 5-year consecutive loss test. See Collins v. Commissioner, 34 T.C. 592 (1960), the taxpayer in which owned the Boston Yanks from 1943 through 1948 and the New York Bulldogs from 1949 through 1951, suffering losses in excess of $50,000 per year during the years 1947-1951. The court held that he was engaged in two separate and independent businesses, so that the 5-year requirement of §270 was not satisfied.

Section 270, which is applicable to individual taxpayers but not to corporations, has

become known as the "Marshall Field" amendment. As explained by Senator Clark on the floor of the Senate:

> The idea has been that [Marshall Field III] was engaged in the activity of starting newspapers and other publications around the country [presumably the primary reference is to the now defunct left-of-center New York newspaper PM] for the purpose of influencing and, as some of us think, corrupting, the public mind, simply as a device to reduce his income taxes. I may say that I voted for the amendment in the committee, under the impression that it would have some effect on Mr. Field's activities. It was on that basis that the amendment was carried in the committee.

Senator Barkley then expressed his understanding that §270 would be inapplicable to Mr. Field because his newspaper enterprises were incorporated, and Senator Clark responded, "Then, of course, I would be against the amendment." Seidman, 1 Legislative History of Federal Income and Excess Profits Tax Laws 1983 (1954). Despite this, the provision was enacted, but whether this was because Senator Barkley's understanding was thought to be erroneous does not appear. By a curious coincidence, Mr. Field's father was the taxpayer in a "racing stable" case, Field v. Commissioner, 26 B.T.A. 116 (1932), and would have been adversely affected by §270 if it had been enacted 20 years earlier.

4. *Wagering losses.* See §165(d), providing that losses from "wagering transactions" shall be allowed only to the extent of the gains from such transactions. It has been held (by a divided court) that this provision dispenses with the need to prove that the losses were incurred in the taxpayer's trade or business or in transactions entered into for profit, i.e., that §165(c) is inapplicable to gambling losses. Humphrey v. Commissioner, 162 F.2d 853 (5th Cir. 1947). Ordinarily, of course, the gambling taxpayer has a profit-seeking motive. But what if he is a tourist in Las Vegas, looking only for excitement and convinced that he will lose?

SMITH v. COMMISSIONER

40 B.T.A. 1038 (1939), affirmed without opinion, 113 F.2d 114 (2d Cir. 1940)

OPPER: Respondent determined a deficiency of $23.62 in petitioners' 1937 income tax. This was due to the disallowance of a deduction claimed by petitioners, who are husband and wife, for sums spent by the wife in employing nursemaids to care for petitioners' young child, the wife, as well as the husband, being employed. The facts have all been stipulated and are hereby found accordingly.

Petitioners would have us apply the "but for" test. They propose that but for the nurses the wife could not leave her child; but for the freedom so secured she could not pursue her gainful labors; and but for them there would be no income and no tax. This thought evokes an array of interesting possibilities. The fee to the doctor, but for whose healing service the earner of the family income could not leave his sickbed; the cost of the laborer's raiment, for how can the world proceed about its business unclothed; the very home which gives us shelter and rest and the food which provides energy, might all by an extension of the same proposition be construed as necessary to the operation of business and to the creation of income. Yet these are the very essence of those "personal" expenses the deductibility of which is expressly denied. I.R.C. [§262].

We are told that the working wife is a new phenomenon. This is relied on to account for the apparent inconsistency that the expenses in issue are now a commonplace, yet have not been the subject of legislation, ruling, or adjudicated controversy. But if that is true it becomes all the more necessary to apply accepted principles to the novel facts. We are not prepared to say that the care of children, like similar aspects of family and household life, is other than a personal concern. The wife's services as custodian of the home and protector of its chil-

dren are ordinarily rendered without monetary compensation. There results no taxable income from the performance of this service and the correlative expenditure is personal and not susceptible of deduction. Rosa E. Burkhart, 11 B.T.A. 275. Here the wife has chosen to employ others to discharge her domestic function and the services she performs are rendered outside the home. They are a source of actual income and taxable as such. But that does not deprive the same work performed by others of its personal character nor furnish a reason why its cost should be treated as an offset in the guise of a deductible item.

We are not unmindful that, as petitioners suggest, certain disbursements normally personal may become deductible by reason of their intimate connection with an occupation carried on for profit. In this category fall entertainment, Blackmer v. Commissioner, 70 Fed. (2d) 255 (C.C.A. 2d Cir.), and traveling expenses, Joseph W. Powell, 34 B.T.A. 655; affd., 94 Fed. (2d) 483 (C.C.A., 1st Cir.), and the cost of an actor's wardrobe, Charles Hutchison, 13 B.T.A. 1187. The line is not always an easy one to draw nor the test simple to apply. But we think its principle is clear. It may for practical purposes be said to constitute a distinction between those activities which, as a matter of common acceptance and universal experience, are "ordinary" or usual as the direct accompaniment of business pursuits, on the one hand; and those which, though they may in some indirect and tenuous degree relate to the circumstances of a profitable occupation, are nevertheless personal in their nature, of a character applicable to human beings generally, and which exist on that plane regardless of the occupation, though not necessarily of the station in life, of the individuals concerned. See Welch v. Helvering, 290 U.S. 111.

In the latter category, we think, fall payments made to servants or others occupied in looking to the personal wants of their employers. David Sonenblick, 4 B.T.A. 986. And we include in this group nursemaids retained to care for infant children.

NOTE

1. *Deduction of child care expenses under §214.* If a married man's income is $10,000, and his wife has an opportunity to earn $3000, the additional tax (at the 1964 rate and assuming two dependent children) will be about $650. Domestic help and other expenses can of course easily take the lion's share of what is left. If the husband's income is $40,000, about half of the wife's earnings will be consumed by taxes. Is the case of the working wife different from that of the small town lawyer who moves to the big city, and makes more in cash, but spends it to maintain his new station in life?

A measure of relief is extended by §214, added by the 1954 Code and somewhat expanded in 1964, which allows a deduction (not to exceed $900) for the expenses of caring for children under thirteen and for certain other dependents "for the purpose of enabling the taxpayer to be gainfully employed." The deduction is available to women, whether married or not, to widowers, and to married men whose spouses are incapacitated or institutionalized. In the case of a married couple, a joint return must be filed, and the deduction is to be reduced by the amount by which their adjusted gross income exceeds $6000 (unless the husband is incapable of self-support because mentally or physically defective or the wife is institutionalized). Note §214(b)(3): neighbors can get the deduction if they employ each other's teen-age children to baby-sit, but not if they employ their own children.

2. *Uniforms and work clothes.* Regs. §1.262-1(b)(8) provides that the cost of a military uniform used by a reserve officer on temporary duty is deductible, but that a regular officer cannot deduct the cost of his uniforms because they merely take the place of clothing that would be required in civilian life. Although this suggests that clothing used during regular working hours cannot be deducted because the taxpayer must clothe himself anyway, the Service has ruled that clothing that must be worn as a condition of em-

ployment and that is not suited for off-duty wear (e.g., the uniforms of police officers, nurses, etc.) can be deducted. Mim. 6463, 1950-1 C.B. 29; but see Rev. Rul. 57-143, 1957-1 C.B. 89 (painter's work clothing, consisting of white cap, shirt, and overalls, not deductible — possibly because items were prescribed by his union rather than employer). Special boots, gloves, protective clothing, and the like are also deductible, but not work clothes that can be worn off duty and are not required by the employer. Roth v. Commissioner, 17 T.C. 1450, 1455 (1952). See also Yeomans v. Commissioner, 30 T.C. 757 (1958) (high-fashion clothing bought by "fashion coordinator" employed by a shoe manufacturer and used only in her work; held, deductible); Jackson v. Commissioner, ¶54,341 P-H Memo T.C. (cost of fur coat, bought by advertising agent for his wife before a business trip where they would "mingle" with potential clients; held, not deductible). See Comment, Income Tax: Deductibility of Uniform and Clothing Expenses by Employees, 36 Calif. L. Rev. 452 (1948).

3. *Other borderline items.* A few of the many other items that have both a personal and a business quality are: medical expenses caused by business activities (supra p. 170); transportation expenses incurred in traveling from home to work (infra p. 224); legal expenses incurred in lawsuits affecting the taxpayer's personal and business reputation (infra p. 266); education expenses (infra p. 258); and residences that are acquired both for occupancy by the taxpayer and as an investment (infra p. 244).

As to property that is acquired for personal use but later dedicated to a profit-making or business purpose, see page 244 infra.

4. *Effect of §262.* Section 262 provides that *"Except as otherwise expressly provided in this chapter,* no deduction shall be allowed for personal, living, or family expenses" (emphasis supplied). Does this merely restate the obvious: viz., that deductions are allowed only to the extent that expenditures can be brought within the scope of a deduction provision? If the baby-sitting expenses in the *Smith* case had been found to be business expenses under §162, would they be disallowed by §262? Would the taxpayer in *Smith* have had a stronger case if §262 had not been enacted?

COMMISSIONER v. FLOWERS

326 U.S. 465, rehearing denied, 326 U.S. 812 (1946)

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case presents a problem as to the meaning and application of the provision of [§162(a)(2)] of the Internal Revenue Code allowing a deduction for income tax purposes of "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business."

The taxpayer, a lawyer, has resided with his family in Jackson, Mississippi, since 1903. There he has paid taxes, voted, schooled his children and established social and religious connections. He built a house in Jackson nearly thirty years ago and at all times has maintained it for himself and his family. He has been connected with several law firms in Jackson, one of which he formed and which has borne his name since 1922.

In 1906 the taxpayer began to represent the predecessor of the Gulf, Mobile & Ohio Railroad, his present employer. He acted as trial counsel for the railroad throughout Mississippi. From 1918 until 1927 he acted as special counsel for the railroad in Mississippi. He was elected general solicitor in 1927 and continued to be elected to that position each year until 1930, when he was elected general counsel. Thereafter he was annually elected general counsel until September, 1940, when the properties of the predecessor company and another railroad were merged and he was elected vice president and general counsel of the newly formed Gulf, Mobile & Ohio Railroad.

The main office of the Gulf, Mobile & Ohio Railroad is in Mobile, Alabama, as was also the main office of its predecessor. When offered the position of gen-

eral solicitor in 1927, the taxpayer was unwilling to accept it if it required him to move from Jackson to Mobile. He had established himself in Jackson both professionally and personally and was not desirous of moving away. As a result, an arrangement was made between him and the railroad whereby he could accept the position and continue to reside in Jackson on condition that he pay his traveling expenses between Mobile and Jackson and pay his living expenses in both places. This arrangement permitted the taxpayer to determine for himself the amount of time he would spend in each of the two cities and was in effect during 1939 and 1940, the taxable years in question.

The railroad company provided an office for the taxpayer in Mobile but not in Jackson. When he worked in Jackson his law firm provided him with office space, although he no longer participated in the firm's business or shared in its profits. He used his own office furniture and fixtures at this office. The railroad, however, furnished telephone service and a typewriter and desk for his secretary. It also paid the secretary's expenses while in Jackson. Most of the legal business of the railroad was centered in or conducted from Jackson, but this business was handled by local counsel for the railroad. The taxpayer's participation was advisory only and was no different from his participation in the railroad's legal business in other areas.

The taxpayer's principal post of business was a the main office in Mobile. However, during the taxable years of 1939 and 1940, he devoted nearly all of his time to matters relating to the merger of the railroads. Since it was left to him where he would do his work, he spent most of his time in Jackson during this period. In connection with the merger, one of the companies was involved in certain litigation in the federal court in Jackson and the taxpayer participated in that litigation.

During 1939 he spent 203 days in Jackson and 66 in Mobile, making 33 trips between the two cities. During 1940 he spent 168 days in Jackson and 102 in Mobile, making 40 trips between the two cities. The railroad paid all of his traveling expenses when he went on business trips to points other than Jackson or Mobile. But it paid none of his expenses in traveling between these two points or while he was at either of them.

The taxpayer deducted $900 in his 1939 income tax return and $1,620 in his 1940 return as traveling expenses incurred in making trips from Jackson to Mobile and as expenditures for meals and hotel accommodations while in Mobile.[1] The Commissioner disallowed the deductions, which action was sustained by the Tax Court. But the Fifth Circuit Court of Appeals reversed the Tax Court's judgment, 148 F.2d 163, and we granted certiorari because of a conflict between the decision below and that reached by the Fourth Circuit Court of Appeals in Barnhill v. Commissioner, 148 F.2d 913.

The portion of [§162(a)] authorizing the deduction of "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business" is one of the specific examples given by Congress in that section of "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." It is to be contrasted with the provision of [§262] of the Internal Revenue Code, . . . disallowing any deductions for "personal, living, or family expenses." And it is to be read in light of the interpretation given it by Sec. 39.23(a)-2 of Treasury Regs.

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1 No claim for deduction was made by the taxpayer for the amounts spent in traveling from Mobile to Jackson. He also took trips during the taxable years to Washington, New York, New Orleans, Baton Rouge, Memphis and Jackson (Tenn.), which were apparently in the nature of business trips for which the taxpayer presumably was reimbursed by the railroad. No claim was made in regard to them.

118, promulgated under the [1939] Internal Revenue Code. This interpretation, which is precisely the same as that given to identical traveling expense deductions authorized by prior and successive Revenue Acts, is deemed to possess implied legislative approval and to have the effect of law. . . . In pertinent part, this interpretation states that

> Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. If the trip is undertaken for other than business purposes, the railroad fares are personal expenses and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including railroad fares, meals, and lodging, are business expenses. . . . Only such expenses as are reasonable and necessary in the conduct of the business and directly attributable to it may be deducted. . . . Commuters' fares are not considered as business expenses and are not deductible.*

Three conditions must thus be satisfied before a traveling expense deduction may be made under [§162(a)(2)]:

> (1) The expense must be a reasonable and necessary traveling expense, as that term is generally understood. This includes such items as transportation fares and food and lodging expenses incurred while traveling.
> (2) The expense must be incurred "while away from home."
> (3) The expense must be incurred in pursuit of business. This means that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer. Moreover, such an expenditure must be necessary or appropriate to the development and pursuit of the business or trade.

Whether particular expenditures fulfill these three conditions so as to entitle a taxpayer to a deduction is purely a question of fact in most instances. . . . And the Tax Court's inferences and conclusions on such a factual matter, under established principles, should not be disturbed by an appellate court. . . .

In this instance, the Tax Court without detailed elaboration concluded that "The situation presented in this proceeding is, in principle, no different from that in which a taxpayer's place of employment is in one city and for reasons satisfactory to himself he resides in another." It accordingly disallowed the deductions on the ground that they represent living and personal expenses rather than traveling expenses incurred while away from home in the pursuit of business. The court below accepted the Tax Court's findings of fact but reversed its judgment on the basis that it had improperly construed the word "home" as used in the second condition precedent to a traveling expense deduction under [§162(a)(2)]. The Tax Court, it was said, erroneously construed the word to mean the post, station or place of business where the taxpayer was employed — in this instance, Mobile — and thus erred in concluding that the expenditures in issue were not incurred "while away from home." The Court below felt that the word was to be given no such "unusual" or "extraordinary" meaning in this statute, that it simply meant "that place where one in fact resides" or "the principal place of abode of one who has the intention to live there permanently." 148 F.2d at page 164. Since the taxpayer here admittedly had his home, as thus defined, in Jackson and since the expenses were incurred while he was away from Jackson, the deduction was permissible.

The meaning of the word "home" in [§162(a)(2)] with reference to a taxpayer residing in one city and working in another has engendered much difficulty and litigation. 4 Mertens, Law of Federal Income Taxation (1942) §25.82. The Tax

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* The Regulations promulgated under the 1954 Code are similar to the old Regulations, except for new provisions governing attendance at conventions and expenses of wives who accompany their husbands on business trips. Regs. §1.162.2. — Ed.

Court and the administrative rulings have consistently defined it as the equivalent of the taxpayer's place of business. See Barnhill v. Commissioner, supra, 4 Cir. On the other hand, the decision below and Wallace v. Commissioner, 9 Cir., 144 F.2d 407, have flatly rejected that view and have confined the term to the taxpayer's actual residence. See also Coburn v. Commissioner, 2 Cir., 138 F.2d 763.

We deem it unnecessary here to enter into or to decide this conflict. The Tax Court's opinion, as we read it, was grounded neither solely nor primarily upon that agency's conception of the word "home." Its discussion was directed mainly toward the relation of the expenditures to the railroad's business, a relationship required by the third condition of the deduction. Thus even if the Tax Court's definition of the word "home" was implicit in its decision and even if that definition was erroneous, its judgment must be sustained here if it properly concluded that the necessary relationship between the expenditures and the railroad's business was lacking. Failure to satisfy any one of the three conditions destroys the traveling expense deduction.

Turning our attention to the third condition, this case is disposed of quickly. There is no claim that the Tax Court misconstrued this condition or used improper standards in applying it. And it is readily apparent from the facts that its inferences were supported by evidence and that its conclusion that the expenditures in issue were non-deductible living and personal expenses was fully justified.

The facts demonstrate clearly that the expenses were not incurred in the pursuit of the business of the taxpayer's employer, the railroad. Jackson was his regular home. Had his post of duty been in that city the cost of maintaining his home there and of commuting or driving to work concededly would be non-deductible living and personal expenses lacking the necessary direct relation to the prosecution of the business. The character of such expenses is unaltered by the circumstance that the taxpayer's post of duty was in Mobile, thereby increasing the costs of transportation, food and lodging. Whether he maintained one abode or two, whether he traveled three blocks or three hundred miles to work, the nature of these expenditures remained the same.

The added costs in issue, moreover, were as unnecessary and inappropriate to the development of the railroad's business as were his personal and living costs in Jackson. They were incurred solely as the result of the taxpayer's desire to maintain a home in Jackson while working in Mobile, a factor irrelevant to the maintenance and prosecution of the railroad's legal business. The railroad did not require him to travel on business from Jackson to Mobile or to maintain living quarters in both cities. Nor did it compel him, save in one instance, to perform tasks for it in Jackson. It simply asked him to be at his principal post in Mobile as business demanded and as his personal convenience was served, allowing him to divide his business time between Mobile and Jackson as he saw fit. Except for the federal court litigation, all of the taxpayer's work in Jackson would normally have been performed in the headquarters at Mobile. The fact that he traveled frequently between the two cities and incurred extra living expenses in Mobile, while doing much of his work in Jackson, was occasioned solely by his personal propensities. The railroad gained nothing from this arrangement except the personal satisfaction of the taxpayer.

Travel expenses in pursuit of business within the meaning of [§162(a)(2)] could arise only when the railroad's business forced the taxpayer to travel and to live temporarily at some place other than Mobile, thereby advancing the interests of the railroad. Business trips are to be identified in relation to business demands and the traveler's business headquarters. The exigencies of business rather than

the personal conveniences and necessities of the traveler must be the motivating factors. Such was not the case here.

It follows that the court below erred in reversing the judgment of the Tax Court.

Reversed.

MR. JUSTICE JACKSON took no part in the consideration or decision of this case.

MR. JUSTICE RUTLEDGE, dissenting.

I think the judgment of the Court of Appeals should be affirmed. When Congress used the word "home" in [§162(a)(2)], I do not believe it meant "business headquarters." And in my opinion this case presents no other question. . . .

Because the taxpayer elected to keep his home in Jackson, rather than move to Mobile, and because his employer did not undertake to pay these expenses, [the Tax Court] viewed the case as being the same as if he had moved to Mobile. In that event, it said, he would have been required to bear the expenses of his own meals and lodging. This is obvious, even though the "as if" conclusion does not follow. The court went on, however, to give the further reason for it: "The situation . . . is, in principle, no different from that in which a taxpayer's place of employment is in one city and for reasons satisfactory to himself he resides in another." It seems questionable whether, in so ruling, the Tax Court has not confused the taxpayer's principal place of employment with his employer's. For on the facts Jackson rather than Mobile would seem more appropriately to be found *his* business headquarters. But, regardless of that, the authorities cited and the Government's supporting argument show that the case was regarded as in essence the commuter's, excepted by the regulations.

Apart from this ruling, the Tax Court made no finding, of fact or law, that respondent was not engaged "in the pursuit of a trade or business"; that he was not "away from home"; that the expenses were not "business expenses" or "business traveling expenses"; or that they were not "ordinary and necessary." Yet by a merry-go-round argument which always comes back to rest on the idea that "home" means "business headquarters," the Government seeks to inject such issues and findings, including a Dobson v. Com'r, 320 U.S. 489, contention, into the Tax Court's determination. I think there was only one issue, a question of law requiring construction of the statute as to the meaning of the word "home" and, if that is resolved against the Government, the Tax Court's judgment has no other foundation on which to stand. Every other contention falls when this one does. All stand if it is valid.

I agree with the Court of Appeals that if Congress had meant "business headquarters," and not "home," it would have said "business headquarters." When it used "home" instead, I think it meant home in everyday parlance, not in some twisted special meaning of "tax home" or "tax headquarters." . . .

Congress gave the deduction for traveling away from home on business. The commuter's case, rightly confined, does not fall in this class. One who lives in an adjacent suburb or city and by usual modes of commutation can work within a distance permitting the daily journey and return, with time for the day's work and a period at home, clearly can be excluded from the deduction on the basis of the section's terms equally with its obvious purpose. But that is not true if "commuter" is to swallow up the deduction by the same sort of construction which makes "home" mean "business headquarters" of one's employer. If the line may be extended somewhat to cover doubtful cases, it need not be lengthened to infinity or to cover cases as far removed from the prevailing connotation of commuter as this one. Including it pushes "commuting" too far, even for these times of rapid transit. . . . The arm of the tax-gatherer reaches far. In my judgment

it should not go the length of this case. Congress has revised [§162(a)(2)] once to overcome niggardly construction.[1] It should not have to do so again.

WRIGHT v. HARTSELL

305 F.2d 221 (9th Cir. 1962)

Before POPE, HAMLEY and KOELSCH, Circuit Judges.

KOELSCH, Circuit Judge.

This is another of those numerous cases involving the question whether a construction worker, in computing his income subject to tax, is entitled to deduct expenses incurred in traveling to and from work. The facts are undisputed. Richard V. Hartsell is a non-itinerant journeyman pipe-fitter and plumber. Beginning in 1950 he has continuously maintained his regular place of abode in Pocatello, Idaho. He is a member of the local union for his trade and has secured employment solely through the hiring hall that the union maintains at Pocatello. He has not been continuously employed by any one concern, nor has he worked in any particular locality. Rather, he has had numerous jobs with different employers and has worked not only in and near Pocatello, but also at other places, as far away as 90 miles. His rate of pay was not affected by the distance of the work from Pocatello, but whenever he was required to travel more than five miles then the job was regarded as outside the so-called "free-zone" and he was paid a fixed sum as compensation for the extra travel.

All Hartsell's jobs from June 1954 until June 1956 were at the Atomic Energy Commission site in Southeastern Idaho, where the Federal Government is conducting atomic research. He was a construction worker and was employed by contractors who were engaged in various construction projects. In this two-year period he had four jobs with three different contractors. His first job was with J. F. Pritchard and Company and lasted from June 1954 until April 1955; he next worked three weeks for Morrison-Knudsen Co., Inc.; then from July to September 1955 he again worked for Pritchard and finally from October until the following June, he was employed by Kaiser Engineers.

Each time, save the last when he voluntarily quit, his "lay-off" was due to the reduction of the size of the crew or the completion of the particular project; and on each occasion, when he found himself out of work, he reported to the union hiring hall and after some interval of unemployment was referred to a new job.

The AEC site encompasses an area of more than 1,500 square miles situated in a vast desert remote from any town or place of habitation. It is 70 miles from Pocatello and 46 miles from the town of Arco. No one is allowed there except on business, and access into the grounds is gained by a single road with a control gate at the entrance. No living accommodations were provided and no transportation was furnished for construction workers.

Hartsell traveled back and forth from Pocatello to his work each day. Some of the times he rode with others, and on other occasions he drove his own automobile. During 1955, the tax year in question, he made a total of 132 round trips to and from Pocatello, for which he received from his employers a travel allowance of $1,356. In his income tax return for that year filed jointly with his wife, Hartsell treated this sum as travel expense and deducted it from gross income, but the Commissioner disallowed the deduction. Thereupon the Hartsells paid the deficiency and commenced this action for a refund.

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1 The Treasury Regulations in force in 1920 allowed deduction of only the excess of the cost of meals and lodging away from home over the cost at home; and under earlier regulations none of this expense was allowed. Congress inserted the words "all" and "entire" in the 1921 Act to overcome this ruling.

The district court found, in substance, that the Hartsells in fact maintained their home in Pocatello; that the nearest "habitable" community to the AEC site was Arco; that Hartsell's employment with Morrison-Knudsen Co. was "temporary" in nature; that his three jobs with the other two firms were each of "indefinite" duration, and that his travel allowance reflected no more than ordinary and reasonable cost of operating his automobile to and from Pocatello.

The court approved the deduction of the entire expense arising from the "temporary" job with Morrison-Knudsen Co., but limited the deduction in connection with the three jobs that were "indefinite" to the cost of driving from Arco to the work sites. It rendered judgment in favor of the Hartsells but for an amount less than they had sought. The Government alone appealed; the Hartsells filed no cross-appeal. . . .

The Commissioner contends that the word "home" as it appears in section 162(a), connotes the regular post of duty of a taxpayer as well as his place of abode and that therefore, Hartsell's travel expenses were not deductible because they were not incurred away from "home." A number of courts have given the statute this construction and have said "home" is the equivalent of work home or principal place of duty. See Barnhill v. Commissioner, 148 F.2d 913 (4th Cir. 1945); Bixler v. Commissioner, 5 B.T.A. 1181 (1927); Lindsay v. Commissioner, 34 B.T.A. 840 (1936). But in Wallace v. Commissioner, 144 F.2d 407 (9th Cir. 1944), this court unequivocally declared that "home" as it is used in this statute should be given its ordinary and usual meaning, and held that the expenses of a taxpayer who regularly lived in San Francisco but visited Los Angeles on business, met the statutory requirement that she incur the expense while away from home. Accord, Coburn v. Commissioner, 138 F.2d 763 (2 Cir. 1943); Flowers v. Commissioner, 148 F.2d 163 (5th Cir. 1945), rev'd on other grounds, 326 U.S. 465 (1946).

The Commissioner argues that a literal application of the *Wallace* doctrine would permit the use of commuting and other non-deductible personal expense to reduce taxable income, but we think that the third condition imposed by the statute clearly serves to prevent such a wrong result. By virtue of that requirement the cost of transportation, food and lodging is deductible only if directly related to the pursuit of a trade or business. This means that "[t]he exigencies of business rather than the personal conveniences and necessities of this taxpayer must be the motivating factors." Flowers v. Commissioner; or stated even more succinctly, "[t]he job, not the taxpayer's pattern of living, must require the travel." Carragan v. Commissioner, 2 Cir., 197 F.2d 246 (1952).

Some of the circuits appear to read the Supreme Court's opinion in *Flowers* as extending the deduction only to expenses incurred by a taxpayer while pursuing an employer's business, and not to those due to the prosecution of his own trade or occupation. Commissioner v. Puerifoy, 254 F.2d 483 (4th Cir. 1957), aff'd 358 U.S. 59 (1958); Commissioner v. Janss, 260 F.2d 99 (8th Cir. 1958). But we see no warrant for such a construction and conclude both types of expenses are embraced by the statute. See Chandler v. Commissioner, 226 F.2d 467 (1st Cir. 1955); Rev. Rul. 189, 1960-1 Cum. Bull. 60, 62. The statute expressly refers to "trade" as well as "business" expenses and states both may be deducted; and although the Supreme Court held that the expenses under consideration were not allowable because they were not necessitated by the employer's business, nevertheless, the Court also recognized that the third condition was met if there was "a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer." Moreover, in *Flowers* the expenses were clearly non-deductible personal expenses whether considered with reference to the employer's business or the taxpayer's profession.

Where it appears probable that a taxpayer's employment outside the area of

his regular abode will be for a "temporary" or "short" period of time, then his travel expenses are held to be deductible; conversely, if the prospects are that his work will continue for an "indefinite" or "intermediate" or "substantially long" period, then the deduction is disallowed. Compare Burns v. Gray, 287 F.2d 698 (6th Cir. 1961); Claunch v. Commissioner, 264 F.2d 309 (5th Cir. 1959); Commissioner v. Peurifoy; with Harvey v. Commissioner, [283 F.2d 491.][1] The Commissioner has acquiesced in the distinction between "indefinite" and "temporary" employment and has permitted deductions in the latter instance. Rev. Rul. 189, 1960-1 Cum. Bull. 60, 65.

Similarly, deductions are allowed to a public official who is required by law to maintain his actual residence in his home district, but perform his official duties elsewhere. United States v. LeBlanc, 278 F.2d 571 (5th Cir. 1960); Moss v. United States, 145 F. Supp. 10 (W.D.S.C. 1956); Emmert v. United States, 146 F. Supp. 322 (S.D. Ind. 1955). Likewise, a taxpayer who is employed in two widely separated localities is allowed his expenses in traveling to one for the reason that he would be unable to perform his duties without such travel. Chandler v. Commissioner, 226 F.2d 467 (1st Cir. 1955); Sherman v. Commissioner, 16 T.C. 332 (1951); Brown v. Commissioner, 13 B.T.A. 832 (1928). Here again the Commissioner has acquiesced. Rev. Rul. 189, 1960-1 Cum. Bull. 60, 62; Rev. Rul. 604, 1955-2 Cum. Bull. 49; Rev. Rul. 147, 1954-1 Cum. Bull. 51.

The Commissioner, however, argues that the above instances are the only ones in which the deduction can be allowed, and urges that in this case it is immaterial that the expenses were incurred because Hartsell was unable to live at or near the AEC site. We are unable to agree. The fundamental question in determining if an expense claimed as travel expense is dictated by the "exigencies of business" is whether it would be reasonable to expect the particular taxpayer to move his home nearer to the place where he is working. Harvey v. Commissioner, 283 F.2d 491 (9th Cir. 1960); Barnhill v. Commissioner, 148 F.2d 913 (4th Cir. 1945). It is difficult to conceive of a situation which makes it more necessary for a taxpayer to incur travel expenses than the unfitness of the work area for civilized habitation. Such a taxpayer has less choice with respect to his place of abode than the taxpayer who prefers not to live in his work area simply because of the temporary nature of his employment there; his situation is similar to that of the public official who must maintain his home elsewhere, or of the taxpayer with two widely separated jobs, who obviously cannot live simultaneously in both localities. We conclude that a taxpayer's inability to live near his job site is a valid ground for deduction as travel expense of the resulting cost of his transportation, food and lodging. See Crowther v. Commissioner, 269 F.2d 292 (9th Cir. 1959). This is

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1 More precisely, the distinction has customarily been drawn between "temporary" and "indefinite" employment, and in *Harvey* we drew the distinction between "substantially long" and "substantially short" employment. The *Harvey* decision did not reject the distinction which had been developed by other courts, but rather rejected the restrictive method in which it had been applied. Other courts have engaged in the practice of basing the deductibility question on whether the taxpayer was away from home for an "indefinite" period of time, thus assuming that the taxpayer should be expected to change his residence unless he could foresee the termination of his job within a reasonably short period of time. In *Harvey*, we held that the taxpayer should not be expected to change his residence unless he expects to be employed elsewhere for a reasonably long period of time. Thus, the difference between the positions proceeds from a conception of the human instincts which most reasonably govern the members of our society, and perhaps more than other courts, we regarded these instincts as ones of stability rather than mobility.

The present case was decided by the district court before we reached our decision in *Harvey*, and thus the district court relied on the distinction between "temporary" and "indefinite" employment in individually classifying the duration of taxpayer's jobs. But we cannot reconsider the validity of these findings because the question is not before us on this appeal. . . .

not to suggest that a taxpayer need not mitigate his expense by moving as near to the job site as is reasonable; the amount of the deduction must be guaged in that light. Here the district court followed this rule in assessing the refund and its finding that Arco was the nearest habitable community to the AEC site and is supported by the record.

The Commissioner's final point is directed toward the trial court's action in separately classifying each of Hartsell's four jobs either as indefinite or temporary. He argues that the trial court should have made but one finding to the effect that Hartsell's employment at the site was of indefinite duration and that the court's error in not viewing the entire employment was prejudicial because on the basis of the finding that the job with Morrison-Knudsen Co. was temporary, Hartsell was allowed to deduct the entire travel expense incurred in pursuing that job.

We agree with the Commissioner that the determination of a taxpayer's employment in a particular geographical area requires the consideration of all the taxpayer's job prospects. But it does not follow that the court, as finder of fact, must make a single finding regarding the duration of his employment and that the travel expense must be either denied or allowed in its entirety. The crucial problem, we reiterate, is whether a taxpayer's job prospects make it feasible for him to maintain his home near his job site. It is conceivable that these prospects may change from time to time and this is particularly true in the case of the construction worker. Here the court, in effect, found that Hartsell had no prospect of employment beyond the period of the termination of his then current job and on this record such a finding is amply supported. There was no continuity in Hartsell's employment; it was composed of several separate jobs; he performed work on different parts of the projects and was employed at various times by different contractors. Moreover, after each lay-off Hartsell was available for work anywhere throughout Southeastern Idaho; in every instance following a "lay-off" Hartsell was unemployed for an appreciable period of time before securing another job; in every instance he was referred to a job through the union hiring hall; it is true that he was sent back to the AEC site, but he might equally have been directed to any of a number of different localities. It simply appears fortuitous that his work during the period in question was at the AEC site.

The judgment is affirmed.

RUDOLPH v. UNITED STATES

370 U.S. 269 (1962)

PER CURIAM.

The petition for certiorari in this case was granted because it was thought to present important questions involving the definition of "income" and "ordinary and necessary" business expenses under the Internal Revenue Code. 368 U.S. 913. An insurance company provided a trip from its home office in Dallas, Texas, to New York City for a group of its agents and their wives. Rudolph and his wife were among the beneficiaries of this trip, and the Commissioner assessed its value to them as taxable income. It appears to be agreed between the parties that the tax consequences of the trip turn upon the Rudolphs' "dominant motive and purpose" in taking the trip and the company's in offering it. In this regard the District Court, on a suit for a refund, found that the trip was provided by the company for "the primary purpose of affording a pleasure trip . . . in the nature of a bonus, reward, and compensation for a job well done" and that from the point of view of the Rudolphs it "was primarily a pleasure trip in the nature of a vacation. . . ." 189 F. Supp. 2, 4-5. The Court of Appeals approved these findings. 291 F.2d 841. Such ultimate facts are subject to the "clearly erroneous"

rule, cf. Commissioner v. Duberstein, 363 U.S. 278, 289-291 (1960), and their review would be of no importance save to the litigants themselves. The appropriate disposition in such a situation is to dismiss the writ as improvidently granted. See Rice v. Sioux City Memorial Park Cemetery, 349 U.S. 70, 78 n.2 (1955).

MR. JUSTICE FRANKFURTER took no part in the decision of this case.

MR. JUSTICE WHITE took no part in the consideration or decision of this case.

Separate opinion of MR. JUSTICE HARLAN.

Although the reasons given by the Court for dismissing the writ as improvidently granted should have been persuasive against granting certiorari, now that the case is here I think it better to decide it, two members of the Court having dissented on the merits. . . .

The basic facts, found by the District Court, are as follows. Petitioners, husband and wife, reside in Dallas, Texas, where the home office of the husband's employer, the Southland Life Insurance Company, is located. By having sold a predetermined amount of insurance, the husband qualified to attend the company's convention in New York City in 1956 and, in line with company policy, to bring his wife with him. The petitioners, together with 150 other employees and officers of the insurance company and 141 wives, traveled to and from New York City on special trains, and were housed in a single hotel during their two-and-one-half-day visit. One morning was devoted to a "business meeting" and group luncheon, the rest of the time in New York City to "travel, sightseeing, entertainment, fellowship or free time." The entire trip lasted one week.

The company paid all the expenses of the convention-trip which amounted to $80,000; petitioner's allocable share being $560. When petitioners did not include the latter amount in their joint income tax return,[1] the Commissioner assessed a deficiency which was sustained by the District Court, 189 F. Supp. 2, and also by the Court of Appeals, one judge dissenting, in a per curiam opinion, 291 F.2d 841, citing its recent decision in Patterson v. Thomas, 289 F.2d 108, where the same result had been reached. The District Court held that the value of the trip being "in the nature of a bonus, reward, and compensation for a job well done," was income to Rudolph, but being "primarily a pleasure trip in the nature of a vacation," the costs were personal and nondeductible.

I

Under §61 of the 1954 Code was the value of the trip to the taxpayer-husband properly includible in gross income? . . .

In light of the sweeping scope of §61 taxing "all gains except those specifically exempted," Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 430; see Commissioner v. LoBue, 351 U.S. 243, 246; James v. United States, 366 U.S. 213, 219, and its purpose to include as taxable income "any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected," Commissioner v. Smith, 324 U.S. 177, 181, it seems clear that the District Court's findings, if sustainable, bring the value of the trip within the reach of the statute.

Petitioners do not claim that the value of the trip is within one of the statutory exclusions from "gross income" . . . as did the taxpayer in Patterson v. Thomas, 289 F.2d 108, 111-112; rather they characterize the amount as a "fringe benefit" not specifically excluded from §61 by other sections of the statute, yet not in-

1 As I see this case, there is no need to explore whether the proper reporting procedure for a *deductible* expense is not to include it in income in the first place, cf. Treas. Reg. §1.162-17(b), or to "run it through" the taxpayer's income with an offsetting deduction in the same amount.

tended to be encompassed by its reach. Conceding that the statutory exclusions from "gross income" are not exhaustive, as the Government seems to recognize is so under *Glenshaw*, it is not now necessary to explore the extent of any such nonstatutory exclusions.[2] For it was surely within the Commissioner's competence to consider as "gross income" a "reward, or a bonus given to . . . employees for excellence in service," which the District Court found was the employer's primary purpose in arranging this trip. I cannot say that this finding, confirmed as it has been by the Court of Appeals, is inadequately supported by this record.[3]

II

There remains the question whether, though income, this outlay for transportation, meals, and lodging was deductible by petitioners as an "ordinary and necessary" business expense under §162. . . .

Where, as here, it may be arguable that the trip was both for business and personal reasons, the crucial question is whether, under all the facts and circumstances of the case, the purpose of the trip was "related primarily to business" or was, rather, "primarily personal in nature." That other trips to other conventions or meetings by other taxpayers were held to be primarily related to business is of no relevance here; that certain doctors, lawyers, clergymen, insurance agents or others have or have not been permitted similar deductions only shows that in the circumstances of those cases, the courts thought that the expenses were or were not deductible as "related primarily to business."

The husband places great emphasis on the fact that he is an entrapped "organization man," required to attend such conventions, and that his future promotions depend on his presence. Suffice it to say that the District Court did not find any element of compulsion; to the contrary, it found that the petitioners regarded the convention in New York City as a pleasure trip in the nature of a vacation. Again, I cannot say that these findings are without adequate evidentiary support.

The trip not having been primarily a business trip, the wife's expenses are not deductible. It is not necessary, therefore, to examine whether they would or would not be deductible if, to the contrary, the husband's trip was related primarily to business. . . .

I would affirm.

MR. JUSTICE DOUGLAS, with whom MR. JUSTICE BLACK joins, dissenting.

I

It could not, I think, be seriously contended that a professional man, say a Senator or a Congressman, who attends a convention to read a paper or conduct a seminar *with all expenses paid* has received "income" within the meaning of

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2 Petitioners rely on §3401 of the 1954 Code, relating to withholding taxes, and more especially on Treas. Reg. §31.3401(a)-1(b)(10) providing that certain fringe benefits are not considered "wages" subject to withholding. The Government admits that not all "fringe benefits" have been taxed as income, but it is enough to point out here that the withholding tax analogy is not perfect, for payments to laid-off employees from company-financed supplemental unemployment benefit plans are "taxable income" to the employees although not "wages" subject to withholding. Rev. Rul. 56-249, 1956-1 Cum. Bull. 488, as amplified by Rev. Rul. 60-330, 1960-2 Cum. Bull. 46.

3 . . . It is pertinent to note that in addition to the facts referred to supra, the record shows that company-sponsored conventions of the same kind have in recent years been held in Canada, Mexico City, Havana, Colorado and California, places well known for their appeal to tourists, and far removed from the home office in Dallas. While this factor alone does not render the expenses nondeductible, see I.R.S. News Rel. No. IR-394, August 3, 1961, it certainly was a relevant circumstance for the District Court to consider.

the Internal Revenue Code. Nor would it matter, I assume, that he took his wife and that her expenses were also paid. Income has the connotation of something other than the mere payment of expenses. The statute, 26 U.S.C. §61, speaks in terms of financial gain, of compensation for services, "including fees, commissions, and similar items." The form of payment for services covers a wide range. Treasury Regulations §1.61-1 provide:

> Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash.

The formula "all expenses paid" might be the disguise whereby compensation "for services" is paid. Yet it would be a rare case indeed where one could conclude that a person who gets only his expenses for attendance at one convention gets "income" in the statutory sense. If this arrangement were regular and frequent or if it had the earmarks of a sham device as a cloak for remuneration, there would be room for fact-finders to conclude that it was evasive. But isolated engagements of the kind here in question have no rational connection with compensation "for services" rendered.

It is true that petitioner was an employee and that the expenses for attending the convention were paid by his employer. He qualified to attend the convention by selling an amount of insurance that met a quota set by the company. Other salesmen also qualified, some attending and some not attending. They went from Dallas, Texas, to New York City, where they stayed two and a half days. One day was given to a business session and a luncheon; the rest of the time was left for social events.

On this record there is no room for a finding of fact that the "expenses paid" were "for services" rendered. They were apparently a proper income tax deduction for the employer. The record is replete with evidence that from management's point of view it was good business to spend money on a convention for its leading agents — a convention that not only kept the group together in New York City, but in transit as well, giving ample time for group discussions, exchanges of experience, and educational training. It was the exigencies of the employment that gave rise to the convention. There was nothing dishonest, illegitimate, or unethical about this transaction. No services were rendered. New York City may or may not have been attractive to the agents and their wives. Whether a person enjoys or dislikes the trip that he makes "with all expenses paid" has no more to do with whether the expenses paid were compensation "for services" rendered than does his attitude toward his job.

In popular understanding a trip to a convention "with all expenses paid" may be an award. Yet the tax laws are filled with exemptions for "awards" which are not considered to be income. The exemption of gifts is one example. Others are the exemptions of the proceeds of life insurance payable at death, disability benefits, the rental values of parsonages, scholarship and fellowship grants, allowances of U.S. employees abroad, mustering-out payments to members of the Armed Forces, etc. Employees may receive from their employers many fringe benefits that are not income. Treasury Regulations §31.3401(a)-1(b)(10) provide:

> Ordinarily, facilities or privileges (such as entertainment, medical services, or so-called "courtesy" discounts on purchases), furnished or offered by an employer to his employees generally, are not considered as wages subject to withholding if such facilities or privileges are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, good will, contentment, or efficiency of his employees.

The fringe benefits of this one convention trip are less obviously income than the fringe benefits listed in the Regulations. For the latter are constantly recur-

ring — day after day, week after week. Moreover, on this record the convention promotes the "efficiency" of the agents as much as the other fringe benefits enumerated in the Regulations.

II

The expenses, if "income," are plainly deductible. The Government, however, says that our problem is to determine "whether it is consistent with the ends of an equitable and workable tax system" to make them such. The problem of designing an "equitable" tax system is, however, for Congress, not for the Court.

The test of deductibility to be applied here is whether the expenses are "ordinary and necessary" in the carrying on of petitioner's business. . . .

Insurance conventions go back at least to 1924 (Report No. 15, Life Insurance Sales Research Bureau, Nov. 1924) and are premised on the idea that agents and companies benefit from the knowledge and increase in morale which result from them. Why they should be treated differently from other conventions is a mystery. It cannot be, as the district judge thought and as the Government seems to argue, because going to New York City is, as a matter of law, a "pleasure trip." If we are in the field of judicial notice, I would think that some might conclude that the weekend in New York City was a chore and that those who went sacrificed valuable time that might better have been spent on the farm, in the woods, or along the seashore.

Moreover, federal revenue agents attending their convention are given a deduction for the expenses they incur. We are advised that

> . . . the Commissioner has recently withdrawn his objections in two Tax Court cases to the deduction of convention expenses incurred by two IRS employees in attending conventions of the National Association of Internal Revenue Employees.
>
> No explanation has been given publicly for the Tax Court action of the Commissioner, it being generally presumed that the IRS employees met the tests of Reg. §1.162-2(d) by showing a sufficient relationship between the trade or business of being an IRS employee and attendance at conventions of the NAIRE. The National Association of Internal Revenue Employees has hailed the Commissioner's actions as setting a precedent which can be cited by IRS employees when taking deductions for expenses incurred in attending NAIRE conventions. [CCH Standard Federal Tax Reports No. 23, April 19, 1961, pt. 1, p. 2.]

It is odd, indeed, that revenue agents need make no accounting of the movies they saw or the nightclubs they attended, in order to get the deduction, while insurance agents must.

III

The wife's expenses are, on this record, also deductible. The Treasury Regulations state in §1.162-2(c):

> Where a taxpayer's wife accompanies him on a business trip, expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. The wife's performance of some incidental service does not cause her expenses to qualify as deductible business expenses. The same rules apply to any other members of the taxpayer's family who accompany him on such a trip.

The civil law philosophy, expressed in the community property concept, attributes half of the husband's earnings to the wife — an equitable idea that at long last was reflected in the idea of income splitting under the federal income

tax law. The wife's contribution to the business productivity of the husband in at least some activities is well known. . . . Business reasons motivated the inclusion of wives in this particular insurance convention. An insurance executive testified at this trial:

Q. I hand you Plaintiff's Exhibit 15, and you will notice it is a letter addressed to "John Doe"; also a bulletin entitled "A New Partner Has Been Formed."

Will you tell us what that consists of?

A. This is a letter addressed to the wife of an agent, a new agent, as we make the contact with him. This letter is sent to his wife within a few days after the contract, enclosing this booklet explaining to her how she can help her husband in the life insurance business. . . . Q. Please tell us, as briefly as you can and yet in detail, how you as agency director for Southland attempt to integrate the wives' performance with the performance of agents in the life insurance business.

A. One of the important functions we have in mind is the attendance at these conventions. In addition to that communication, occasionally there are letters that will be written to the wife concerning any special sales effort that might be desired or promoted. The company has a monthly publication for the agents and employees that is mailed to their homes so the wife will have a convenient opportunity to see the magazine and read it.

At most of our convention program[s], we have some specific reference to the wife's work, and in quite a few of the convention programs we have had wives appear on the program.

Q. Suppose you didn't have the wives and didn't seek to require their attendance at a convention, would there be some danger that your meetings and conventions would kind of degenerate into stag affairs, where the whole purpose of the meeting would be lost?

A. I think that would definitely be a tendency.

I would reverse the judgments below and leave insurance conventions in the same category as conventions of revenue agents, lawyers, doctors, businessmen, accountants, nurses, clergymen and all others, until and unless Congress decides otherwise.

NOTE

1. *Commuting expenses.* As the court in *Flowers* points out (supra p. 214), the cost of driving or commuting to work has long been treated as non-deductible; see Regs. §1.162-2(e). In Bruton v. Commissioner, 9 T.C. 882 (1947), this principle was applied to disallow the deduction of taxi fares paid by a partially paralyzed lawyer to get from his home to his office. See also Marot v. Commissioner, 36 T.C. 238 (1961) (hospital technician on call 24 hours a day; expenses of getting from her home, beaches, theaters, homes of friends, etc. to hospital held non-deductible); Heuer v. Commissioner, 32 T.C. 947 (1959), aff'd per curiam, 283 F.2d 865 (5th Cir. 1960) (river pilot who was assigned daily to work at different docks and wharves; expenses of traveling from home to various locations held non-deductible); Crowther v. Commissioner, 269 F.2d 292 (9th Cir. 1959) (similar facts, except that the taxpayer transported the tools of his trade; deduction allowed).

Since the expense of driving to work is not deductible, does a taxpayer realize income if a group of employees who ride with him reimburse him for their share of the automobile expense? In Rev. Rul. 55-555, 1955-2 C.B. 20, the Internal Revenue Service ruled that the reimbursement is not includible in gross income, so long as the taxpayer cannot "be said to have established a trade or business of transporting workers for hire from which a profit is derived."

2. *Living expenses at place of "temporary" employment.* Is Wright v. Hartsell (supra p. 216) consistent with the *Flowers* case? In Peurifoy v. Commissioner, 27 T.C. 149 (1956), the Tax Court held that the employment of three construction workers who plied their callings at one location after another while their families remained permanently at still another location was "temporary" in the taxable years in question, so that their living expenses at the job (for 20, 12, and 9 months respectively) and in returning to their families were deductible. The Court of Appeals assumed (without conceding) that the

rule applied by the Tax Court was consistent with *Flowers*, but found that the taxpayers had not established that they fell on the "temporary" rather than "indefinite" side of the dividing line. 254 F.2d 483 (4th Cir. 1957). The Supreme Court, in turn, stated that application of the *Flowers* doctrine of "the exigencies of business" would prohibit the deductions, but that the Tax Court "has engrafted an exception which allows a deduction . . . when the taxpayer's employment is 'temporary' as contrasted with 'indefinite' or 'indeterminate.' . . ." Since the government had not challenged the validity of this exception to the general rule, the Court held that the issue was "a narrow question of fact" upon which the Court of Appeals (in reversing the Tax Court finding as "clearly erroneous") made a fair assessment of the record so that Supreme Court intervention was not appropriate. Three Justices dissented, on the ground that construction workers of this type are "away from home" for the duration of their jobs; a contrary view, they said, "means that the taxpayer who is forced to travel from place to place to pursue his trade must carry his home on his back regardless of the fact that he maintains his family at an abode which meets all accepted definitions of 'home.'" 358 U.S. 59 (1958). For more on the traveling construction worker, see Rev. Rul. 60-189, 1960-1 C.B. 60, which contains a discussion, unusually full for a ruling, of the travel expense cases. See also Claunch v. Commissioner, 264 F.2d 309 (5th Cir. 1959), a characteristically tart opinion by Chief Judge Hutcheson on the same subject.

Although the Internal Revenue Service apparently does not intend to use *Peurifoy* as an excuse to jettison the "temporary" employment principle, it argued in Burns v. Gray, 287 F.2d 698 (6th Cir. 1961), involving the travel expenses of an itinerant race track starter whose family stayed behind, that "one must consider all the different places of [his] employment during that year, ascertain the place where he has been employed for the longest period during that time and then construe that place as his 'home' within the meaning of the statute." The argument failed and the deductions were allowed.

What is the status of the taxpayer who has a regular employer (unlike the construction worker in Wright v. Hartsell) but takes a temporary job with another employer in another city, where he is accompanied by his family (e.g., a college professor who teaches for the summer at another college, or a businessman who accepts a short-term government assignment in Washington)? On Fulbright grantees, see Dowd v. Commissioner, 37 T.C. 399 (1961) (Fulbright lecturer is "away from home" while in Japan for two academic years with family); Rev. Rul. 62-2, 1962-2 C.B. 9.

3. *Permanent or indefinite post without housing facilities for taxpayer's family.* The *Flowers* case has been applied to disallow the living expenses of a taxpayer even though it was difficult or impossible for him to bring his family to his business or occupational headquarters. Bercaw v. Commissioner, 165 F.2d 521 (4th Cir. 1948) (army officer living on post; no quarters for family); Warren v. Commissioner, 13 T.C. 205 (1949) (wartime housing shortage at taxpayer's occupational headquarters); Rev. Rul. 55-571, 1955-2 C.B. 44 (army officer overseas; family not permitted to accompany him); Formel v. Commissioner, ¶50,221 P-H Memo T.C. (engineer in Soviet Russia).

Does Wright v. Hartsell reject these cases?

4. *Homeless taxpayers.* In James v. United States, 308 F.2d 204 (9th Cir. 1962), a traveling salesman who spent the entire year "on the road" and had no permanent place of abode was denied a deduction for his living expenses in Reno, which he regarded as his headquarters because there he maintained bank and brokerage accounts, stored personal belongings, filed his income tax return, and made major purchases; although the court said that he could deduct "that *portion* of the cost of his meals and lodging, in Reno or elsewhere, which was in fact attributable to the exigencies of business," no criteria were suggested for making such an allocation and the court may have had in mind only the added cost of his meals when he was entertaining customers. Similar cases are: Fisher v. Commissioner, 230 F.2d 79 (7th Cir. 1956) (itinerant musician whose family traveled with him); Martin v. Commissioner, 44 B.T.A. 185 (1941) (seaman with no home ashore). In Gustafson v. Commissioner, 3 T.C. 998 (1944), however, an unmarried salesman who traveled continuously as a national representative of his employer was allowed to deduct his entire living expenses for the taxable year; his married sister maintained a room in her house for him, which he occupied on occasional weekends, and this was held to be his "home."

5. *Public officials.* In LeBlanc v. Commissioner, cited by the court in Wright v. Hartsell, a judge of the Louisiana Supreme Court was held to be "away from home" while in New Orleans, where the court sat; he was required by law to maintain a residence in the district from which he was elected. Query: could he have deducted the cost of living in his district rather than the cost of living in New Orleans?

The final sentence of §162(a) provides that a member of Congress shall be considered to have his "home" in the election district he represents, but that his living expenses (presumably in Washington) shall not be deductible beyond $3000 per year. This provision was enacted after it was held in Lindsay v. Commissioner, 34 B.T.A. 840 (1936), that a Congressman's "home" was Washington, so that his living expenses there were non-deductible, and that the cost of trips to his district to keep in touch with constituents were non-deductible campaign expenses. As to members of state legislatures, see I.T. 3842, 1947-1 C.B. 11.

6. *Two places of employment or business.* What if the taxpayer in the *Flowers* case had continued to practice law in Jackson after he took the Mobile railroad job? The Tax Court would apparently permit his expenses in Mobile to be deducted if the business activity in Jackson was substantial, even though the income therefrom was less than the Mobile income. Sherman v. Commissioner, 16 T.C. 332 (1951) (four judges dissenting); see also Chandler v. Commissioner, 226 F.2d 467 (1st Cir. 1955). The Internal Revenue Service, however, takes the position that the "home" of a taxpayer having two widely separated posts of duty is his principal business post, so that he is not "away from home" while there, but that he may deduct his living expenses while at the minor post even if his family is located there. Rev. Rul. 55-604, 1955-2 C.B. 49; see also Rev. Rul. 54-147, 1954-1 C.B. 51 (professional baseball players). Rev. Rul. 55-604 is concerned with an employee whose employer assigned him to two posts of duty, but it seems applicable to an employee with two employers and to a self-employed person having two headquarters as well. Does the *Flowers* case shed any light on this issue? Is there — or should there be — any distinction between transportation expenses and the cost of meals for the taxpayer with two posts?

A related problem is whether, if husband and wife work in different localities, either of them can deduct the expenses of being away from the "home." In Wallace v. Commissioner, 144 F.2d 407 (9th Cir. 1944), an actress domiciled in San Francisco (where her husband worked) was allowed to deduct the expenses of a six months' stay in Hollywood. The court's reasoning is somewhat weakened by the subsequently decided *Flowers* case, but in Stairwalt v. Commissioner, ¶52,261 P-H Memo T.C., the Tax Court hinted (though deciding the case before it on another ground) that the wife should be allowed to deduct such expenses because of "the possible considerations of public policy inherent in creating as few inducements as possible to the maintenance of separate domiciles for husband and wife." In Hammond v. Commissioner, 213 F.2d 43 (5th Cir. 1954), however, where the husband worked in Baton Rouge but the wife worked and maintained the home in New Orleans, the husband's expenses were disallowed; see also Coerver v. Commissioner, 36 T.C. 252 (1961).

7. *Function of §162(a)(2).* Since "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business" are deductible by virtue of the opening clause of §162(a), what is added by the specific reference in §162(a)(2) to "traveling expenses . . . while away from home in the pursuit of a trade or business"? In at least one respect, the former phrase is broader than the latter: a taxpayer who is not "away from home" (e.g., a salesman who travels only in his home town; a traveling salesman who has no home) can deduct his automobile expenses and railroad fares as "business expenses" though they do not fit the terms of §162(a)(2).

How far must a taxpayer travel to be "away from home"? Can the taxpayer in Wright v. Hartsell deduct the cost of his lunches at the job site? What about lunches bought by a New York attorney who flies to Washington on business and flies back the same day? See Hanson v. Commissioner, 298 F.2d 391 (1962) (taxpayer need not be away overnight to be "away from home"); Rev. Rul. 61-221, 1961-2 C.B. 34 (taxpayer must be away for a period substantially longer than normal working hours so that sleep or rest is necessary); Rev. Rul. 63-239, 1963-2 C.B. 87 (non-acq. in *Hanson* case).

Note that §212, relating to the expenses of an individual in profit-seeking activities that

do not constitute a trade or business, contains no specific reference to traveling expenses. If an investor goes to another city to inspect his income-producing property, can he deduct his expenses in the same way as a businessman who makes a trip to inspect his business property?

8. *Business conventions.* With the opinions in *Rudolph*, compare Patterson v. Thomas, 289 F.2d 108 (5th Cir. 1961), in which the field representative of an insurance company was held to have realized additional income when his company paid for his attendance at its annual convention for 3½ days, during which 5 hours, at most, were spent in formal business meetings, most of the time being devoted to sightseeing, golf, and other recreational activities. The taxpayer was allowed to deduct a portion of his expenses, proportionate to the time devoted to business meetings, but his transportation expenses were disallowed in toto. (The taxable year before the court was 1956; §274, discussed below, was not enacted until 1962.) The court found that the presence of wives served no business purpose, rejecting the theory of the District Court that they served a "business" purpose in keeping the men from the "misconduct" that may occur at "stag affairs." One judge dissented, primarily on the ground that the "organization" man dare not refuse an invitation from his employer that is in reality a command: "[The organization man] weds a wife, but he marries a corporation too. Every waking hour the company's needs, the company's business, the company's welfare is drummed into this person whose inner satisfactions are likewise warped into the corporate image through status symbols of job assignments, titles and prerogatives." The dissenting judge, though evidently not much of an organization man himself, did not discuss whether the deduction should have been disallowed on the ground that the system contravened public policy, perhaps because he found it to be "as American as Bedloe's Island, hot dogs, Grand Canyon, Rhapsody in Blue, Chautauqua, P.T.A., Golden Gate, Rose Bowl or Wagon Train." Patterson v. Thomas, 289 F.2d 108 (5th Cir. 1961); see also 11 A.F.T.R.2d 722 (opinion on remand, allocating expenses between business and non-business time).

9. *The 1962 legislation: lavish expenses and combined business-personal trips.* The Revenue Act of 1962 imposed a number of restrictions on the deduction of travel and entertainment expenses (known in the trade as "T and E"), discussed infra page 230. Note at this point, however, that the parenthetical phrase in §162(a)(2) was amended to exclude "amounts which are lavish or extravagant under the circumstances." This language — what does it mean? — was substituted by the Senate for a provision in the House bill that had restricted the taxpayer to a "reasonable allowance for meals and lodging."

Note also the enactment in 1962 of §274(c), disallowing travel expenses to the extent that they are allocable to personal activities rather than to the taxpayer's trade or business or §212 activities — a result that was reached without explicit legislative authority in Patterson v. Thomas, supra. Since §274(c) applies only to individual taxpayers, what is the status of expenses paid by the employer for an employee who is on a combined business-personal trip? Section 274(c) is inapplicable if the trip lasts less than a week or if less than 25 per cent of the time is devoted to personal activities.

In 1964, §274(c) was amended (retroactively) to exclude travel within the United States; it remains in effect, however, for foreign travel.

The substantiation rules discussed infra page 234 are applicable to travel as well as entertainment expenses.

10. *Moving expenses.* In Rev. Rul. 54-429, 1954-2 C.B. 53, the Internal Revenue Service ruled that if an employer transfers an employee from one post to another, the employer's payment or reimbursement of the cost of moving the employee and his family is "not compensatory in nature," and hence not taxable as income, but that if the expense is paid by the employee, §262 bars a deduction. If the employee moved to take a job with a new employer, the Service's position was that the employee realized income if he was reimbursed, and could not deduct his expenses. Rev. Rul. 55-140, 1955-1 C.B. 317; see also Ferebee v. Commissioner, 39 T.C. 801 (1963), and cases there cited.

Section 217, enacted in 1964, alters these rules by allowing the employee to deduct "moving expenses" (as defined) even though he is taking a post with a new employer, provided (a) his new principal place of work is at least twenty miles farther from his former residence than was his old principal place of work, and (b) he is a full-time employee for at

least thirty-nine weeks during the twelve-month period immediately following his arrival at the new principal place of work. These conditions mean that a disparity will continue between the expenses of moving to enter the service of a new employer and those incurred on a transfer to a different office of the same employer; but the disparity is substantially narrowed.

Frequently the employee who is transferred by his employer to a new post of employment or who moves to take a new job will receive assistance in disposing of his home (e.g., payment by the employer of the real estate commission, guarantee against loss on the sale, etc.). The Tax Court holds that such payments are added compensation to the employee; see the *Ferebee* case, supra; Bradley v. Commissioner, 324 F.2d 610 (4th Cir. 1963) (accord).

11. *References.* Note, A House Is Not a Tax Home, 49 Va. L. Rev. 125 (1963); Haddleton, Traveling Expenses "Away from Home," 17 Tax L. Rev. 261 (1962); Comment, Living Expenses While "Away from Home"; Business or Personal, 19 U. of Chi. L. Rev. 534 (1952); McDonald, Travel and Entertainment Expenses, 11 N.Y.U. Inst. on Fed. Taxation 1173 (1953).

SCHULZ v. COMMISSIONER
16 T.C. 401 (1951)

ARUNDELL, Judge: The respondent has disallowed as a deduction from the petitioner's 1945 taxable income the sum of $9,304.40 claimed as entertainment expense, and a $400 item claimed as advertising expense. There is no serious dispute as to whether either of these sums was spent; the issue is whether they are deductible.

Entertainment expenses are allowed as a deduction from gross income only to the extent that they are "ordinary and necessary" in carrying on a trade or business. Section [162(a)] of the Internal Revenue Code. The requirements that the expense must be both ordinary and necessary must be strictly complied with, Helvering v. Welch, 290 U.S. 111, and whether contested expenditures are ordinary and necessary is primarily a question of fact. Commissioner v. Heininger, 320 U.S. 467. Proof is required that the purpose of the expenditure was primarily business rather than social or personal, and that the business in which taxpayer is engaged benefited or was intended to be benefited thereby. Louis Boehm, 35 B.T.A. 1106.

During 1945 petitioner elaborately entertained buyers and others connected with the jewelry business, personally spending about $7,000. In addition thereto approximately $2,000 was expended by his wife and employees on luncheons, drinks, weekend visits, conventions, suppers, theaters, and nightclubs. Approximately $3,400 of the $7,000 expended by petitioner personally was spent on suppers, theaters, and nightclubs and other forms of evening entertainment. On these occasions petitioner would bring his wife and the party or parties he was entertaining would also bring their wives. There is little to distinguish these occasions from the usual social gatherings among friends to renew acquaintanceship and enjoy a pleasant evening. They bear little semblance to the usual gatherings of business people at restaurants or other places of entertainment which serve primarily as congenial meeting places for the discussion or negotiation of business matters. Petitioner made no attempt to show that the evening entertainment he offered his guests served this purpose or that all of it was directly related to the operations of his business.

These gatherings may have been desirable and helpful to the present and future success of petitioner's business, but this is usually true of all entertaining done by business or professional people for the purpose of acquiring or retaining the favor of patrons and clients. Such expenditures are nonetheless nondeductible absent a showing that they were ordinary and necessary to the taxpayer's business within

the meaning of [§162(a)] of the Internal Revenue Code. In Louis Boehm, supra, we stated:

We do not think the burden of proof is met by the petitioner's argument that in general, membership in social, political, and fraternal organizations is helpful in obtaining clients through contacts made thereby or the citing of one instance of gaining a client through acquaintance made at a political club. No evidence has been introduced to show that any part or all of the expenditures in question were so closely related to the conduct of the petitioner's business as to have been appropriate, helpful, usual, or necessary. It is noted that in cases where expenditures of a social nature have been held to be deductible business expenses proof was presented to show that such expenditures had a direct relation to the conduct of a business or the business benefits expected. Such proof has not been presented here to show that the expenditures are deductible under [§162(a)].

After taking into consideration the nature of the entertainment provided by the petitioner and the fact that it was undertaken at a time when he had more business than he could handle, we are not convinced that all of the expenditures in issue were made for purely business reasons or that the entire cost of such entertainment may be characterized as ordinary and necessary expense incident to the carrying on of the petitioner's business. An expense is deductible only if it complies with the strict requirements of [§162(a)] and does not constitute a personal expense expressly disallowed by [§262].

Moreover, the petitioner's attempt to deduct such nondeductible items as the cost of repairing an automobile, the cost of hotel rooms, tips, and meals on two occasions when, after a night of entertaining customers, he remained in New York after missing the train home, and the inclusion of $200 which had been placed in the petty cash fund but was not expended on entertainment, all create doubt as to the accuracy of the total deduction.

On the other hand, we are convinced that some part of the expenditures was prompted by strictly business considerations and should be characterized as ordinary and necessary expenses. Applying the rule of Cohan v. Commissioner,* we have reached an approximation after a careful consideration of the testimony of petitioner and his wife and a close examination of the memoranda and other ex-

* In Cohan v. Commissioner, 39 F.2d 540, 543 (2d Cir. 1930), the court (per Judge L. Hand) made an approximation of the business expenses incurred by George M. Cohan under these circumstances: "In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board [of Tax Appeals] he estimated that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following fiscal year, fifty-five thousand dollars in all. The Board refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer, whose inexactitude is of his own making." See also Walet v. Commissioner, 31 T.C. 461, 471 (1958), aff'd per curiam, 272 F.2d 694-695 (5th Cir. 1959): "Nor does the evidence show whether there was any proximate relationship between the expenditures and the alleged business. Certainly, the word 'entertainment' is not a magic formula entitling one to deduction without inquiry as to whether the entertainment in question really had a significant bearing upon the conduct of the alleged business. The situation is one that is susceptible of gross abuse, and it is not too much to ask that one claiming such deductions show that the expenditures in question were genuinely related to the conduct of a business. We cannot say on the record before us that any of the claimed expenditures could qualify for deduction; accordingly, there is no occasion to make an approximation such as was indicated in Cohan v. Commissioner."

As indicated infra, the scope of the *Cohan* doctrine was much reduced by the enactment of §274(d) (relating to substantiation of travel and entertainment expenses) in 1962. — Ed.

hibits received in evidence. From all this evidence, we have concluded that $5,500 fairly represents the amount spent by the petitioner for ordinary and necessary business entertainment in 1945 and that amount is properly deductible under [§162(a)] of the Internal Revenue Code.

The petitioner has included in his advertising expense the sum of $400 spent in entering his horse named "Schulztime" in a horse show and for such items as horse show programs and trophies. Petitioner has not satisfactorily shown how these expenditures were calculated to advertise or publicize his business. There is no evidence that the petitioner called the attention of those persons attending the horse shows to the fact that he was a dealer in watches by advertising in the horse show program. Cf. Rodgers Dairy Co., 14 T.C. 66. There is an inference in the record that the name "Schulztime" was relied on by petitioner to publicize his business but if this be true the name chosen was so subtle and the entry of a horse in a show so far removed from the petitioner's business that it could not reasonably have been expected to publicize the business. In our opinion, the $400 so expended was not an ordinary and necessary business expense within the meaning of section [162(a)] of the Code and the Commissioner's disallowance of the deduction is sustained.

NOTE

1. *The background of the 1962 legislation.* In 1962, Congress enacted §274, which restricts or disallows entirely certain expenses for entertainment, amusement, recreation, and business gifts. The immediate impetus for this legislation was President Kennedy's Tax Message of April 20, 1961, urging that "The slogan — 'It's deductible' — should pass from our scene." But proposals for administrative or legislative restrictions on "T and E" (travel and entertainment) deductions have a longer history, having been advanced with increasing frequency as descriptions of the "expense account society" like the following became more common in the years after World War II:

> In cities like New York, Washington and Chicago it is safe to say that at any given moment well over half of all the people in the best hotels, the best nightclubs and the best restaurants are charging the bill as an expense account item to their companies, which in turn are charging it to the government in the form of tax deductions. [Life, March 9, 1953, p. 140.]

In "Europe's Lighter Side," in the New York Herald-Tribune, July 20, 1954, p. 21, Art Buchwald reported that many Europeans had been puzzled by promising business deals that, after being discussed with them by vacationing Americans, had never been closed. He states:

> The only way we've been able to appease the Europeans is to explain that the Americans weren't being malicious. They were just trying to deduct their trip from their income tax. After it's explained, the European is always mollified. If there's one thing a European understands, it's tax evasion.

Another source of dissatisfaction with the growing amount of travel and entertainment deductions was the degree of discretion vested in the subordinate employees of the Internal Revenue Service who pass on the propriety of such deductions. After an extended investigation in 1951-1952, a subcommittee of the House Committee on Ways and Means, headed by Congressman Cecil R. King, reported:

> A second way to reduce possible corrupt practices in the Bureau [of Internal Revenue] is to minimize the opportunities and temptation. For example, under a leading judicial decision [the *Cohan* case], a taxpayer who claims large business de-

ductions but has not kept any records to substantiate the claim is entitled to a reasonable allowance for the claimed expenses, which must be estimated by the Revenue Agent. Stricter requirements for keeping of reasonably detailed records by taxpayers would eliminate the necessity for discretionary determination of the proper expense deduction, and with it, any possible temptation for the Revenue Agent to allow an improperly large deduction in exchange for some private benefit extended to him by the taxpayer.

This record-keeping proposal, aside from its tendency to eliminate opportunities for corruption in the Bureau, should reduce the risk that the great multitude of taxpayers who have no substantial business deductions may feel that some persons having such opportunity to claim deductions are not paying their fair share of taxes. . . .

Recent high tax rates have resulted in attempts by some business organizations to reward key personnel with tax-free personal benefits. These may take the form of free automobiles, airplanes, vacations, housing, or servants, all theoretically for the benefit of the employer. Of like character is the practice of allowing overly liberal expense accounts to employees whose duties involve travel or business entertainment; sometimes the employer may tolerate padding of the expense account by the employee as a way of giving him tax-free income. The opportunity for a limited segment of the taxpaying population to receive such tax-free benefits jeopardizes public confidence in the impartial imposition of taxes. As a basis for possible legislation, the subcommittee recommends that definite information be obtained as to the prevalence of these practices and as to the amount of revenue lost thereby. Your subcommittee has been advised that the Treasury Department will obtain these statistics and report to the Congress on the problem. [Report to House Committee on Ways and Means, Subcommittee on Administration of the Internal Revenue Laws 29 (1952).]

An extended report made to Congress in 1961 in support of President Kennedy's proposals was summarized by Secretary of the Treasury Dillon as follows:

Turning now to expense accounts, much has been said and written about the abuses in this area. Abuses through expense accounts take a variety of forms. Tax deductible entertainment allowances frequently are a means by which business provides tax-free compensation to favored employees or business associates. The seller invites the buyer to his yacht or hunting lodge, the buyer may reciprocate with lavish parties and nightclub entertainment, and both then charge it off as a business expense. Some of this is done because of the businessman's own desire to obtain such luxuries tax free; much of it is done in response to a competitive pressure which has in large measure been created by our tax law and not by the dictates of business. As a result, therefore, there are few of the luxuries of life, such as vacations at fancy resorts, club memberships, and cruises which a large number of taxpayers cannot in some way deduct on tax returns as business expenses. As the President stated, the time has come when our tax laws should cease to encourage luxury spending as a charge on the Federal Treasury.

I have here a four-part document illustrating the abuses in the entertainment area. This document demonstrates that tighter enforcement of present law will not suffice; corrective legislation is necessary.

Part One of this document summarizes the result of a recent audit by the Internal Revenue Service. This audit was undertaken last September by the Treasury Department as a step in meeting the directive of the Congress, set forth in the Public Debt and Tax Rate Extension Act of 1960, that the Secretary of the Treasury make a report as soon as practicable during the 87th Congress on the progress of an enforcement program, initiated by the Internal Revenue Service in 1960, relating to expenses for entertainment, travel, yachts, hunting lodges, club dues, and similar items. Although this audit covered only 38,000 returns, it shows that these returns claimed deductions totaling $5.7 million for club dues, $2 million for theater tickets and similar amusements, over $1 million for hunting lodges and fishing camps, $2.6 million for yachts,

and $11.5 million for business gifts. Most significantly, the audit shows that only a small portion of these expenses can be disallowed under existing law.

The difficulty in administering present law is shown by the fact that, even though most of the claimed expenditure for entertainment was allowed under the existing generous standards, almost 50 percent of the returns had to be adjusted by Internal Revenue agents. These adjustments resulted in the disallowance of $28.3 million of claimed travel and entertainment expense. In addition, it was determined that $29.5 million of the claimed deductions constituted unreported income in the nature of dividends or additional compensation to stockholders, officers, or employees.

Part Two of the document consists of a report by the Commissioner of Internal Revenue on the very serious problems encountered in administering present law relating to travel and entertainment expenses.

Part Three contains a summary of some court decisions and administrative cases illustrative of the type of entertainment expenditure which is deductible under existing law. As the introduction to this part states, when judicial decisions permit the cost of a safari to Africa undertaken by a hunting enthusiast and his wife to be deducted as an expense for advertising dairy milk [Sanitary Farms Dairy, Inc. v. Commissioner, 25 T.C. 463 (1955)], one cannot expect revenue agents to question successfully the business necessity for duck hunting or nightclubbing with business associates.

Part Four of the document contains a compilation of recent comments on expense accounts and business gifts appearing in newspapers and other periodicals. These comments illustrate the widespread public concern, shared by many in the business community, with expense account abuses.

The supplemental statement contains detailed proposals for carrying out the President's recommendation to disallow certain entertainment expenses. The characteristic feature of all of these expenses is that they confer substantial personal benefits which are in large measure a substitute for personal living expenses. Under these detailed proposals, expenses for entertaining guests at such functions as parties, nightclubs, theaters, country clubs and fishing trips would be disallowed in full. So also would be expenses for luxury entertainment facilities such as yachts, hunting lodges, and swimming pools, as well as for such items as country club dues. The cost of so-called business gifts would be disallowed to the extent it exceeds an annual limitation of $10 for each recipient.

Expenditures for food and beverages generally would be disallowed, although several exceptions are made. One exception relates to food or beverages provided primarily to employees on business premises. Another exception covers the cost of food and beverages consumed in the course of conducting business, but not in excess of a fixed amount per day for each individual involved. This figure could be somewhere in the range of $4 to $7. A deduction for the cost of food and lodging while on business trips would be limited to twice the maximum per diem rate authorized to be paid to Federal employees. At the present time this rate for travel in the United States is $12 per day, but the Bureau of the Budget has recommended to the Congress that this figure be raised to $15. Therefore, the per diem limitation applicable to business travel would be $30 if the Congress accepts the recommendation of the Bureau of the Budget. Finally, where a business trip is combined with a vacation, a portion of the cost of travel to the business destination would be disallowed.

I believe that these are realistic recommendations which recognize the legitimate needs of business while at the same time eliminating the lavish expenditure for personal benefit which has, in the past, been charged off to the American taxpayer. They would increase revenues by at least $250 million per year.

The legislative proposals described by Secretary Dillon were pruned substantially as they passed through successive stages of congressional action. See Lipoff, Entertainment and Related Expenses Under Legislative Attack, 17 Tax L. Rev. 183 (1962).

As enacted, the provisions consist of the amendment to §162(a)(2) (the prohibition on "lavish and extravagant" travel expenses), described supra page 227, and of the enactment of a new provision, §274, which is described below. Hereafter, "T and E" deductions

must not only qualify as business expenses under §162 (or as "non-business" expenses under §212), but also meet the requirements of §274.

2. *Entertainment expenses.* Section 274(a) provides that the cost of "an activity which is of a type generally considered to constitute entertainment, amusement, or recreation" is deductible only if it was (a) "directly related to" the "active conduct" of the taxpayer's trade or business, or (b) "associated with" the active conduct of his business and directly preceded or followed "a substantial and bona fide business discussion." The Regulations cite, as examples of entertainment that is "directly related" to active conduct of the taxpayer's business, the entertainment of business representatives and civic leaders at the opening of a hotel, the maintenance of a "hospitality suite" at a business convention where the taxpayer's products are displayed or discussed, and the award of vacation trips as prizes to the taxpayer's dealers. By contrast, entertainment at theaters, night clubs, and sporting events, or at country clubs and cocktail lounges in groups that include persons other than business associates, is said by the Regulations not to be "directly related" (unless the taxpayer clearly proves the contrary).

If not "directly related" to the "active conduct" of the taxpayer's business, entertainment expenses are deductible only if the entertainment directly preceded or followed a substantial business discussion and was "associated with" the active conduct of the taxpayer's business. The Regulations cite only two instances of "associated" entertainment: entertainment at business conventions and similar meetings if a business program is the principal activity of the meeting; and entertainment on the day of a business discussion or, if the persons entertained are from out of town, on the preceding or following evening.

If the expense is attributable to a "facility" used for entertainment, amusement, or recreation (e.g., rent, maintenance, or depreciation of a yacht, hunting lodge, or swimming pool; or dues paid to a social or athletic club), §274(a)(1)(B) permits a deduction only if the expense was "directly related" to active conduct of the business and the facility was used "primarily for the furtherance" of the business. The latter requirement is interpreted by the Regulations (in keeping with the Senate Report) as requiring a more than 50 per cent business use of the facility. Regs. §1.274-2(e)(4). Note, however, §274(f), providing that §274 does not prohibit a deduction that does not depend on §162 or §212; thus the owner of a hunting lodge may deduct interest on the mortgage, real estate taxes, and damage caused by casualty even though it is not used primarily for business purposes.

A number of exceptions to the rules just summarized are given in §274(e), of which the most important are food and drink furnished under circumstances "generally considered to be conducive to a business discussion" or furnished to the taxpayer's employees on his business premises; expenses treated as compensation to employees; recreation for the benefit of rank and file employees; and certain reimbursed expenses. Out of what might seem an excess of caution, §274(e)(9) exempts "entertainment sold to customers," thus making it clear that the owner of a night club or theater can deduct the cost of providing entertainment for his customers.

The student should spend an hour or two with the Regulations under §274, observing the effort to give meaning to such terms as "directly related to," "associated with," "active conduct," "directly preceding or following," "substantial and bona fide business discussion," and "primarily for the furtherance" of business. If Congress had simply added a statutory warning that expenses for entertainment are deductible only if "clearly essential" to the conduct of the taxpayer's business or to his §212 activities, would it have accomplished substantially less — or more — than §274(a)?

What is the effect of §274(a), or of §162(a) itself, on a businessman's entertainment expenses if his customers become his friends, or his friends become his customers? Consider the following extract from Challenge Manufacturing Co. v. Commissioner, 37 T.C. 650, 659 (1962), disallowing deductions claimed by a corporation for entertaining business associates on its yacht:

> In the second place, even when guests having some "business" connection with Challenge [the corporate taxpayer] were aboard, it is far from clear to us that their presence on the yacht in any particular instance was proximately related to the business of Challenge so as to form the basis for deduction. It is entirely normal for

friendships to develop with some of those that one meets in business transactions, and we cannot say on this record that a number of the so-called "business" guests were not also social friends of Castendyck [the corporation's sole shareholder] and were not invited on the yacht because Castendyck found them companionable and congenial, wholly apart from business reasons. The mere fact that they may have been "business" contacts as well would not render deductible the cost of entertainment if it in fact was furnished primarily for social or personal reasons. The deduction is one that is peculiarly susceptible of abuse, and it has been decided that the one claiming it must show a proximate relationship between the entertainment and the business of the taxpayer. Ralph E. Larrabee, 33 T.C. 838, 843; Eugene H. Walet, Jr., 31 T.C. 461, 471, affirmed 272 F.2d 694 (C.A. 5). The possible fact that some of the persons aboard may have been helpful to Challenge in some circumstances hardly establishes that they were invited solely for business reasons, or that their entertainment was in any significant way responsible for any benefits accruing to the corporation. We are far from convinced by the evidence that all of the alleged "business" visitors were entertained for business rather than social reasons.

Section 274(a)(1)(A) speaks of "an activity which is of a type generally considered to constitute entertainment, amusement, or recreation," and Regs. §1.274-2(b)(ii) states that:

> This objective test precludes arguments such as that "entertainment" means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations.

Is this so clear? See U.S. Equipment Co. v. Commissioner, ¶63,261 P-H Memo T.C. (cost of operating hydroplane racing boats for dominant purpose of advertising a business held deductible, for pre-1962 years, as business expenses).

3. *"Lavish and extravagant" expenses.* Although a statutory prohibition on "lavish and extravagant" expenses is to be found only in §162(a)(2) (relating to travel expenses away from home), the Regulations impose this limitation on all expenses for entertainment. Regs. §1.274-1. Does this restriction, which also appears in the Senate Report (S. Rept. No. 1881, 87th Cong., 2d Sess. 30 (1962)), emerge from the final clause of §274(a)(1), providing that the deduction "shall in no event exceed the portion of such [expense] directly related to, or . . . associated with" active conduct of the business?

4. *Business gifts.* Section 274(b) provides that "gifts" (defined as items that are excluded from the recipient's gross income under §102 and not under any other provision) are deductible only to the extent of $25 per donee per year. Exceptions are made for certain advertising and promotional material, as well as for gifts of tangible personal property costing not more than $100 and awarded to employees for length of service or safety achievement. (Query: would a safety award be excluded from the recipient's income by §74, without regard to §102, and hence be deductible regardless of amount?)

On the deductibility of Christmas presents, etc., see Regs. §1.162-9, providing that "donations made to employees and others, which do not have in them the element of compensation . . . are not deductible from gross income"; Arc Realty Co. v. Commissioner, 34 T.C. 484, 494 (1960). How did the Internal Revenue Service reconcile Rev. Rul. 59-58, quoted supra pages 124-125, with Regs. §1.162-9?

5. *Substantiation.* By virtue of §274(d), no deduction may be taken for traveling expenses, entertainment, or business gifts unless the taxpayer "substantiates by adequate records or by sufficient evidence corroborating his own statement" the amount, the time and place of the travel or entertainment or the date and description of the gift, the business purpose of the expense, and his business relationship to the person entertained or the donee. This requirement of substantiation is intended to overrule the *Cohan* case in this area. The Treasury is authorized to dispense with some or all of these requirements, and this power has been exercised as to some expenditures (e.g., expenditures under $25 other than for lodging; mileage allowances not exceeding 15 cents per mile and per diem allowances up to $25 per day for meals and lodging used by an employer to reimburse his employees). Regs. §1.274-5(c)(2)(iii); Rev. Rul. 63-13, 1963-1 C.B. 69.

6. *Entertainment expenses as income to recipient.* Section 274(e)(3) acknowledges that

an employer's expenditures for entertainment may constitute additional income to an employee; but this possibility antedates, and according to the Regulations is not affected by, the enactment of §274. Regs. §1.274-1. In Rev. Rul. 57-130, 1957-1 C.B. 108, the Internal Revenue Service, moved by advertisements "describing a tax-deductible executive rehabilitation plan which certain hotels have instituted to assist in keeping an individual fit," announced that an employer's expenditures for "reconditioning and health-restoring services" provided to its executives would be deductible — but only by the employer — as additional compensation to the executive. See also Williams v. United States, 245 F.2d 559 (5th Cir. 1957); Rev. Rul. 57-502, 1957-2 C.B. 118. It should also be noted that a corporation's expenditures for entertainment may constitute a disguised dividend to its shareholders (infra p. 647), if they are the persons who use the yacht or occupy the Florida hotel suite.

A related question is whether the taxpayer who takes a customer to lunch or the theater under circumstances permitting a deduction for the customer's entertainment can also deduct his own share of the bill. In Sutter v. Commissioner, 21 T.C. 170, 173 (1953), the court spoke of:

> the stubborn thread of a single problem which has never apparently been squarely and expressly passed upon. . . . When a taxpayer in the course of supplying food or entertainment or making other outlays customarily regarded as ordinary and necessary includes an amount attributable to himself or his family such as the payment for his own meals, is that portion of the expenditure an ordinary and necessary business expense on the one hand or a nondeductible personal item on the other? . . . [W]e think the presumptive nondeductibility of personal expenses may be overcome only by clear and detailed evidence as to each instance that the expenditure in question was different from or in excess of that which would have been made for the taxpayer's personal purposes.

In Rev. Rul. 63-144, 1963-30 I.R.B. 23, the Service summarized the decisions as holding that "a taxpayer canot obtain a deduction for the portion of his meal cost which does not exceed an amount he would normally spend on himself" and said that it did not intend to depart from its practice of applying this rule "largely to abuse cases where taxpayers claim deductions for substantial amounts of personal living expenses." No reference was made to the cost of theater tickets and other entertainment expenses.

7. *Payment by employee of expenses attributable to employer's business.* If the taxpayer is an employee, entertainment expenses may be disallowed because they were paid in carrying on his employer's, rather than his own, trade or business. An example is Roach v. Commissioner, 20 B.T.A. 919 (1930) (where the dichotomy was especially formal because the taxpayer and his wife owned all the stock of the corporation by which he was employed); see also Jergens v. Commissioner, 17 T.C. 806 (1951). This barrier can be hurdled by the taxpayer who shows that part of *his* job is the entertainment, at his own expense, of his employer's customers. In Henricks v. Commissioner, ¶49,269 P-H Memo T.C., the taxpayer, an advertising solicitor for Time, Inc., was able to rely upon a memorandum from his employer stating:

> Mr. Luce and other Management officers have often emphasized that TIME salesmen are paid high salaries because selling is not a routine job and makes demands on a man's time and money that cannot be accounted for minute-by-minute or penny-by-penny. There are many expenses incidental to selling which the salesman is not expected to recover from the Company on top of his salary.

Often, however, less formal evidence of the employee's obligation to pay some expenses himself is sufficient. See, e.g., Schmidlapp v. Commissioner, 96 F.2d 680 (2d Cir. 1938).

This rule — permitting a deduction to be taken only if the expense or other item is the taxpayer's own — has been encountered previously, Holden v. Commissioner, supra page 191, and it is of general applicability. See Note, Deductibility of Expenses Incurred for the Benefit of Another, 66 Harv. L. Rev. 1508 (1953); Lempert, Who Can Deduct a Business Expense? 11 Tax L. Rev. 433 (1956).

If the employee who makes an expenditure that would normally be discharged by

the employer is employed by a corporation of which he is the principal or sole shareholder, the deduction might be disallowed on the ground that he is making a capital contribution, or a gift, to the employer. See Kahn v. Commissioner, 26 T.C. 273 (1956). But what is the rationale for denying the deduction if the employee has no such proprietary interest in the employer?

8. *Entertainment expenses incurred by attorneys, etc.* In Handelman v. Commissioner, ¶61,171 P-H Memo T.C. (1961), an attorney argued that the publicity he obtained from winning, or merely from entering, yachting races was of sufficient benefit to his law "business" to justify deducting part of the cost of maintaining his yacht under §162(a). The government had allowed one fourth of the maintenance expenses, either on this theory or because the taxpayer entertained clients aboard, and the court refused to increase the allowance. The taxpayer and his partner had partnership income of $46,000; the partnership deducted $13,000 of this for "promotion and entertainment" and the taxpayer deducted another $2500 on his personal return. Query: does entertainment on this scale by lawyers, doctors, and other professionals raise a special question of propriety under §162? See page 281 infra.

See also Tonkoff v. United States, 219 F. Supp. 16 (E.D. Wash. 1963) (estimating entertainment expenses of lawyer who was active in National Association of Claimants' Counsel of America; judge commented that "while I should be hesitant to liken the business of a lawyer such as taxpayer to that of the producer and entrepreneur Cohan, I have, nevertheless, witnessed some formidable courtroom productions by the devotees of NACCA — they are of a demonstrative and outgoing type").

9. *References.* Blum, How to Succeed in a Business Deduction Without Really Trying, 40 Taxes 1074 (1962); Knickerbocker, Entertainment and Related Deductions Under the Revenue Act of 1962, 31 Fordham L. Rev. 639 (1963); Emmanuel and Lipoff, Travel and Entertainment: The New World of Section 274, 18 Tax L. Rev. 487 (1963); Hauser, Problems Relating to the Proposed T & E Regulations, 15 Tax Exec. 222 (1963).

UNITED STATES v. GILMORE
372 U.S. 39 (1963)

MR. JUSTICE HARLAN delivered the opinion of the Court.

In 1955 the California Supreme Court confirmed the award to the respondent taxpayer of a decree of absolute divorce, without alimony, against his wife Dixie Gilmore. The case before us involves the deductibility for federal income tax purposes of that part of the husband's legal expense incurred in such proceedings as is attributable to his successful resistance of his wife's claims to certain of his assets asserted by her to be community property under California law. The claim to such deduction, which has been upheld by the Court of Claims, 290 F.2d 942, is founded on [§212(2)], which allows as deductions from gross income

> . . . ordinary and necessary expenses . . . incurred during the taxable year . . . for the . . . conservation . . . of property held for the production of income.

Because of a conflict of views among the Court of Claims, the Courts of Appeals, and the Tax Court regarding the proper application of this provision,[1] and the continuing importance of the question in the administration of the federal income tax laws, we granted certiorari on the Government's petition. The case was first argued at the last Term and set for reargument at this one.

At the time of the divorce proceedings, instituted by the wife but in which the husband also cross-claimed for divorce, respondent's property consisted primarily of controlling stock interests in three corporations, each of which was a franchised General Motors automobile dealer. As president and principal managing officer

1 Compare Lewis v. Commissioner, 253 F.2d 821 (C.A. 2d Cir.), and Douglas v. Commissioner, 33 T.C. 349, with Gilmore v. United States, 290 F.2d 942 — the present case — and Baer v. Commissioner, 196 F.2d 646 (C.A. 8th Cir.).

of the three corporations, he received salaries from them aggregating about $66,800 annually, and in recent years his total annual dividends had averaged about $83,000. His total annual income derived from the corporations was thus approximately $150,000. His income from other sources was negligible.

As found by the Court of Claims the husband's overriding concern in the divorce litigation was to protect these assets against the claims of his wife. Those claims had two aspects: *first,* that the earnings accumulated and retained by these three corporations during the Gilmores' marriage (representing an aggregate increase in corporate net worth of some $600,000) were the product of respondent's personal services, and not the result of accretion in capital values, thus rendering respondent's stockholdings in the enterprises pro tanto community property under California law; *second,* that to the extent that such stockholdings were community property, the wife, allegedly the innocent party in the divorce proceeding, was entitled under California law to more than a one-half interest in such property.

The respondent wished to defeat those claims for two important reasons. *First,* the loss of his controlling stock interests, particularly in the event of their transfer in substantial part to his hostile wife, might well cost him the loss of his corporate positions, his principal means of livelihood. *Second,* there was also danger that if he were found guilty of his wife's sensational and reputation-damaging charges of marital infidelity, General Motors Corporation might find it expedient to exercise its right to cancel these dealer franchises.

The end result of this bitterly fought divorce case was a complete victory for the husband. He, not the wife, was granted a divorce on his cross-claim; the wife's community property claims were denied in their entirety; and she was held entitled to no alimony.

Respondent's legal expenses in connection with this litigation amounted to $32,537.15 in 1953 and $8,074.21 in 1954 — a total of $40,611.36 for the two taxable years in question. The Commissioner of Internal Revenue found all of these expenditures "personal" or "family" expenses and as such none of them deductible. [§262.] In the ensuing refund suit, however, the Court of Claims held that 80% of such expense (some $32,500) was attributable to respondent's defense against his wife's community property claims respecting his stockholdings and hence deductible under [§212(2)] as an expense "incurred . . . for the . . . conservation . . . of property held for the production of income." In so holding the Court of Claims stated:

> Of course it is true that in every divorce case a certain amount of the legal expenses are incurred for the purpose of obtaining the divorce and a certain amount are incurred in an effort to conserve the estate and are not necessarily deductible under [§212(2)], but when the facts of a particular case clearly indicate [as here] that the property, around which the controversy evolves, is held for the production of income and without this property the litigant might be denied not only the property itself but the means of earning a livelihood, then it must come under the provisions of [§212(2)]. . . . The only question then is the allocation of the expenses to this phase of the proceedings. [290 F.2d, at 947.]

The Government does not question the amount or formula for the expense allocation made by the Court of Claims. Its sole contention here is that the court below misconceived the test governing [§212(1) and (2)] deductions, in that the deductibility of these expenses turns, so it is argued, not upon the *consequences* to respondent of a failure to defeat his wife's community property claims but upon the *origin* and *nature* of the claims themselves. So viewing Dixie Gilmore's claims, whether relating to the existence or division of community property, it is contended that the expense of resisting them must be deemed nondeductible "per-

sonal" or "family" expense under [§262], not deductible expense under [§212(1) and (2)]. For reasons given hereafter we think the Government's position is sound and that it must be sustained.

I

For income tax purposes Congress has seen fit to regard an individual as having two personalities: "one is [as] a seeker after profit who can deduct the expenses incurred in that search; the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures." [2] The Government regards [§212(1) and (2)] as embodying a category of the expenses embraced in the first of these roles.

Initially, it may be observed that the wording of [§212(2)] more readily fits the Government's view of the provision than that of the Court of Claims. For in context "conservation of property" seems to refer to operations performed with respect to the property itself, such as safeguarding or upkeep, rather than to a taxpayer's retention of ownership in it. But more illuminating than the mere language of [§212(1) and (2)] is the history of the provision.

Prior to 1942 [the Code] allowed deductions only for expenses incurred "in carrying on any trade or business," the deduction presently authorized by [§162(a)]. In Higgins v. Commissioner, 312 U.S. 212, this Court gave that provision a narrow construction, holding that the activities of an individual in supervising his own securities investments did not constitute the "carrying on of a trade or business," and hence that expenses incurred in connection with such activities were not tax deductible. Similar results were reached in United States v. Pyne, 313 U.S. 127, and City Bank Co. v. Helvering, 313 U.S. 121. The Revenue Act of 1942 (56 Stat. 798, §121), by adding what is now [§212(1) and (2)], sought to remedy the inequity inherent in the disallowance of expense deductions in respect of such profit-seeking activities, the income from which was nonetheless taxable.

As noted in McDonald v. Commissioner, 323 U.S. 57, 62, the purpose of the 1942 amendment was merely to enlarge "the category of incomes with reference to which expenses were deductible." And committee reports make clear that deductions under the new section were subject to the same limitations and restrictions that are applicable to those allowable under [§162(a)]. Further, this Court has said that [§212(1) and (2)] "is comparable and in pari materia with [§162(a)]," providing for a class of deductions "coextensive with the business deductions allowed by [§162(a)], except for" the requirement that the income-producing activity qualify as a trade or business. Trust of Bingham v. Commissioner, 325 U.S. 365, 373, 374.

A basic restriction upon the availability of a [§162(a)] deduction is that the expense item involved must be one that has a business origin. That restriction not only inheres in the language of [§162(a)] itself, confining such deductions to "expenses . . . incurred . . . in carrying on any trade or business," but also follows from [§262], expressly rendering nondeductible "in any case . . . [p]ersonal, living, or family expenses." In light of what has already been said with respect to the advent and thrust of [§212(1) and (2)], it is clear that the "[p]ersonal . . . or family expenses" restriction of [§262] must impose the same limitation upon the reach of [§212(1) and (2)] — in other words that the only kind of expenses deductible under [§212(1) and (2)] are those that relate to a "business," that is, profit-seeking, purpose. The pivotal issue in this case then becomes: was this part of respondent's litigation costs a "business" rather than a "personal" or "family" expense?

[2] Surrey and Warren, Cases on Federal Income Taxation, 272 (1960).

The answer to this question has already been indicated in prior cases. In Lykes v. United States, 343 U.S. 118, the Court rejected the contention that legal expenses incurred in contesting the assessment of a gift tax liability were deductible. The taxpayer argued that if he had been required to pay the original deficiency he would have been forced to liquidate his stockholdings, which were his main source of income, and that his legal expenses were therefore incurred in the "conservation" of income-producing property and hence deductible under [§212(2)]. The Court first noted that the "deductibility [of the expenses] turns wholly upon the nature of the activities to which they relate" (343 U.S., at 123), and then stated:

> Legal expenses do not become deductible merely because they are paid for services which relieve a taxpayer of liability. That argument would carry us too far. It would mean that the expense of defending almost any claim would be deductible by a taxpayer on the ground that such defense was made to help him keep clear of liens whatever income-producing property he might have. For example, it suggests that the expense of defending an action based upon personal injuries caused by a taxpayer's negligence while driving an automobile for pleasure should be deductible. Section [212(1) and (2)] never has been so interpreted by us. . . .
>
> While the threatened deficiency assessment . . . added urgency to petitioner's resistance of it, neither its size nor its urgency determined its character. It related to the tax payable on petitioner's gifts. . . . The expense of contesting the amount of the deficiency was thus at all times attributable to the gifts, as such, and accordingly was not deductible.
>
> If, as suggested, the relative size of each claim, in proportion to the income-producing resources of a defendant, were to be a touchstone of the deductibility of the expense of resisting the claim, substantial uncertainty and inequity would inhere in the rule. . . . It is not a ground for . . . [deduction] that the claim, if justified, will consume income-producing property of the defendant. [343 U.S., at 125-126.]

In Kornhauser v. United States, 276 U.S. 145, this Court considered the deductibility of legal expenses incurred by a taxpayer in defending against a claim by a former business partner that fees paid to the taxpayer were for services rendered during the existence of the partnership. In holding that these expenses were deductible even though the taxpayer was no longer a partner at the time of suit, the Court formulated the rule that "where a suit or action against a taxpayer is directly connected with, or . . . proximately resulted from, his business, the expense incurred is a business expense. . . ." 276 U.S., at 153. Similarly, in a case involving an expense incurred in satisfying an obligation (though not a litigation expense), it was said that "it is the origin of the liability out of which the expense accrues" or "the kind of transaction out of which the obligation arose . . . which [is] crucial and controlling." Deputy v. du Pont, 308 U.S. 488, 494, 496.

The principle we derive from these cases is that the characterization, as "business" or "personal," of the litigation costs of resisting a claim depends on whether or not the claim *arises in connection with* the taxpayer's profit-seeking activities. It does not depend on the *consequences* that might result to a taxpayer's income-producing property from a failure to defeat the claim, for, as *Lykes* teaches, that "would carry us too far" [3] and would not be compatible with the basic lines of expense deductibility drawn by Congress.[4] Moreover, such a rule would lead to ca-

[3] The Treasury Regulations have long provided: "An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability." Treas. Reg. (1954 Code) §1.212-1(m); see Treas. Reg. 118 (1939 Code) §39.23(a)-15(k).

[4] Expenses of contesting tax liabilities are now deductible under §212(3) of the 1954 Code. This provision merely represents a policy judgment as to a particular class of expenditures otherwise nondeductible, like extraordinary medical expenses, and does not cast any doubt on the basic tax structure set up by Congress.

pricious results. If two taxpayers are each sued for an automobile accident while driving for pleasure, deductibility of their litigation costs would turn on the mere circumstance of the character of the assets each happened to possess, that is, whether the judgments against them stood to be satisfied out of income- or non-income-producing property. We should be slow to attribute to Congress a purpose producing such unequal treatment among taxpayers, resting on no rational foundation.

Confirmation of these conclusions is found in the incongruities that would follow from acceptance of the Court of Claims' reasoning in this case. Had this respondent taxpayer conducted his automobile-dealer business as a sole proprietorship, rather than in corporate form, and claimed a deduction under [§162(a)], the potential impact of his wife's claims would have been no different than in the present situation. Yet it cannot well be supposed that [§162(a)] would have afforded him a deduction, since his expenditures, made in connection with a marital litigation, could hardly be deemed "expenses . . . incurred . . . in carrying on any trade or business." Thus, under the Court of Claims' view expenses may be even less deductible if the taxpayer is carrying on a trade or business instead of some other income-producing activity. But it was manifestly Congress' purpose with respect to deductibility to place all income-producing activities on an equal footing. And it would surely be a surprising result were it now to turn out that a change designed to achieve equality of treatment in fact had served only to reverse the inequality of treatment.

For these reasons, we resolve the conflict among the lower courts on the question before us (note 1, supra) in favor of the view that the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was "business" or "personal" and hence whether it is deductible or not under [§212(1) and (2)]. We find the reasoning underlying the cases taking the "consequences" view unpersuasive.

Baer v. Commissioner, 196 F.2d 646, upon which the Court of Claims relied in the present case, is the leading authority on that side of the question. There the Court of Appeals for the Eighth Circuit allowed a [§212(2)] expense deduction to a taxpayer husband with respect to attorney's fees paid in a divorce proceeding in connection with an alimony settlement which had the effect of preserving intact for the husband his controlling stock interest in a corporation, his principal source of livelihood. The court reasoned that since the evidence showed that the taxpayer was relatively unconcerned about the divorce itself "[t]he controversy did not go to the question of . . . [his] liability [for alimony] but to the manner in which . . . [that liability] might be met . . . without greatly disturbing his financial structure"; therefore the legal services were "for the purpose of conserving and maintaining" his income-producing property. 196 F.2d, at 649-650, 651.

It is difficult to perceive any significant difference between the "question of liability" and "the manner" of its discharge, for in both instances the husband's purpose is to avoid losing valuable property. Indeed most of the cases which have followed *Baer* have placed little reliance on that distinction, and have tended to confine the deduction to situations where the wife's alimony claims, if successful, might have completely destroyed the husband's capacity to earn a living. Such may be the situation where loss of control of a particular corporation is threatened, in contrast to instances where the impact of a wife's support claims is only upon diversified holdings of income-producing securities. But that rationale too is unsatisfactory. For diversified security holdings are no less "property held for the production of income" than a large block of stock in a single company. And as was pointed out in *Lykes,* supra, at 126, if the relative impact of a claim on the

income-producing resources of a taxpayer were to determine deductibility, substantial "uncertainty and inequity would inhere in the rule."

We turn then to the determinative question in this case: did the wife's claims respecting respondent's stockholdings arise in connection with his profit-seeking activities?

II

In classifying respondent's legal expenses the court below did not distinguish between those relating to the claims of the wife with respect to the *existence* of community property and those involving the *division* of any such property. Nor is such a break down necessary for a disposition of the present case. It is enough to say that in both aspects the wife's claims stemmed entirely from the marital relationship, and not, under any tenable view of things, from income-producing activity. This is obviously so as regards the claim to more than an equal division of any community property found to exist. For any such right depended entirely on the wife's making good her charges of marital infidelity on the part of the husband. The same conclusion is no less true respecting the claim relating to the existence of community property. For no such property could have existed but for the marriage relationship.[5] Thus none of respondent's expenditures in resisting these claims can be deemed "business" expenses, and they are therefore not deductible under [§212(2)].

In view of this conclusion it is unnecessary to consider the further question suggested by the Government: whether that portion of respondent's payments attributable to litigating the issue of the existence of community property was a capital expenditure or a personal expense. In neither event would these payments be deductible from gross income.

The judgment of the Court of Claims is reversed and the case is remanded to that court for further proceedings consistent with this opinion.

It is so ordered.

MR. JUSTICE BLACK and MR. JUSTICE DOUGLAS believe that the Court reverses this case because of an unjustifiably narrow interpretation of the 1942 amendment to the Internal Revenue Code and would accordingly affirm the judgment of the Court of Claims.

NOTE

1. *Scope of the Gilmore case.* In a companion case, United States v. Patrick, 372 U.S. 53 (1963), the Supreme Court held non-deductible a husband's payments to his and his wife's attorneys for services in connection with another divorce settlement. In *Patrick,* the wife owned 28 per cent of the stock of a family corporation by which the husband (who also owned 28 per cent) was employed, and she owned a 20 per cent interest in real property occupied by the corporation. Most of the attorneys' fees were incurred in settling these business interests, by "rearranging" the ownership of the corporation, leasing the real property for a long term, and transferring certain interests to a trust for the children. The Court held that the *Gilmore* case was controlling: "We find no significant distinction in the fact that [in *Patrick*] the legal fees for which the deduction is claimed were paid for arranging a transfer of stock interests, leasing real property, and creating a trust rather than for conducting litigation. These matters were incidental to litigation brought by respondent's wife, whose claims arising from respondent's personal and family life were the origin of the property arrangements." 372 U.S. at 57.

[5] The respondent's attempted analogy of a marital "partnership" to the business partnership involved in the *Kornhauser* case, supra, is of course unavailing. The marriage relationship can hardly be deemed an income-producing activity.

How far does the "but for" argument carry in this area? If the wife in *Gilmore* or *Patrick* had obtained stock in the family corporation by gift during marriage, or at the time of divorce, would the cost of later litigation alleging mismanagement of the corporation or a wrongful refusal to pay dividends be a personal expense as to either or both spouses because the stock would not have been owned by the wife but for the marriage? Can a wife deduct fees paid by her to an attorney to obtain, increase, or collect an allowance for alimony? Does the answer depend upon whether local law requires her husband to defray her legal expenses? On whether the alimony is taxable to her under §71 (periodic alimony payments)? See Regs. §1.262-1(b)(7).

In the *Lewis* case, cited in footnote 1 of the *Gilmore* opinion, the Court of Appeals for the Second Circuit denied a deduction for expenses incurred by the taxpayer in defending himself in an incompetency proceeding instituted by his wife, the deduction having been claimed because the proceeding threatened the sale of books of which he was the author and publisher. The Tax Court had denied the deduction on the theory that the taxpayer's primary purpose in contesting the incompetency proceedings was to maintain his freedom rather than to protect his business. The Court of Appeals was prepared to accept the opposite assumption, but did not want tax liability to turn on the fact that "one taxpayer prizes his personal liberty more than his property, while another values property more highly"; it concluded that the proper test was whether the charges which the taxpayer was contesting were "directed toward him as a person" or "directed to his occupational activities as such." The court expressed its disagreement with Draper v. Commissioner, 26 T.C. 201 (1956) (entertainer allowed to deduct expense of libel action, ending in hung jury, against person who called him a Communist, where action was to re-establish his professional income), but approved the result in Howard v. Commissioner, 202 F.2d 28 (9th Cir. 1953) (army officer allowed to deduct expense of defending himself in court-martial, the charge being conduct unbecoming an officer, viz., failing to pay alimony to his ex-wife). See also I.T. 3551, 1942-1 C.B. 42 (expense incurred by government official in defending himself against charges of engaging in political activities contrary to Hatch Act; held, non-deductible, apparently because the acts that stimulated the charges were not part of taxpayer's official duty); see also Salt v. Commissioner, infra page 282, allowing legal expenses in connection with subpoena issued by House Committee on Un-American Activities to be deducted.

Does *Gilmore* suggest a different result in any of the foregoing situations?

In *Gilmore,* the court indicates that a judgment against the taxpayer for an automobile accident "while driving for pleasure" cannot be deducted. What if he is on his way to or from work, or is on a "frolic and detour" during working hours? See Plante v. United States, 226 F. Supp. 314 (D.N.H. 1963) (accident occurred on detour during business hours; held deductible).

2. *Expenses in determining or resisting tax liability.* In the *Lykes* case, cited in *Gilmore,* the Supreme Court held that the taxpayer could not deduct legal fees incurred in resisting a gift tax deficiency asserted against him and based on a higher valuation for certain donated shares of a family corporation than had been used by the taxpayer in computing the gift tax due. The Court held that the gift tax liability arose only because of a personal transaction — the gift to members of the taxpayer's family — and that the legal expenses were therefore non-deductible living expenses under §262. The Regulations under the 1939 Code allowed the expenses of determining *income* tax liability to be deducted, Regs. 118, §39.23(a)-15(k), and in 1954 Congress overruled the *Lykes* case by enacting §212(3). The statutory provision refers to expenses incurred by an individual "in connection with the determination, collection, or refund of any tax." See Kaufmann v. United States, 227 F. Supp. 807 (W.D. Mo. 1963) (cost of obtaining ruling on tax consequences of proposed exchange of stock held deductible under §212(3)); United States v. Davis, 370 U.S. 65 (1962) (§212(3) does not embrace payment by husband to divorced wife's attorney for advice regarding her tax liability). As to the cost of concocting a "sham transaction" or of defending against a criminal prosecution for tax evasion, see page 282 infra.

Section 212(3), like the other subsections of §212, applies to individuals only. What is the status of comparable expenses incurred by a corporation?

GEVIRTZ v. COMMISSIONER

123 F.2d 707 (2d Cir. 1941)

Before SWAN, CHASE, and FRANK, Circuit Judges.

FRANK, Circuit Judge.

Taxpayer, a woman of considerable wealth, was, for some years prior to 1926, a resident of Mt. Vernon, where, at one time, she had built and later sold a garden apartment house. Conceiving the idea of constructing another garden apartment, she purchased a tract of several acres with this in view, but she became dissatisfied with the location and sold it in 1925. Shortly thereafter she advised a real estate agent at Mt. Vernon that she was interested in acquiring another tract of land upon which to build an apartment house. Early in 1926 she purchased a one-acre parcel for $32,000, paying $7,000 in cash and giving back a mortgage for $25,000. The deed contained restrictions, providing that no building could be erected on the premises for any trade, calling, or business whatever, the premises being restricted to dwelling purposes by means of homes for use or value of not less than $15,000, and built not more than one to each 75 feet of frontage, and that no building erected on the land could be used as a tenement house or apartment house. At the time of the hearing of the present proceeding by the Board, these restrictions had not been removed, although it was believed, we may assume with good reason, that they could be. Immediately following the acquisition of this property, the taxpayer learned, for the first time, that several large apartment house projects were being contemplated in Mt. Vernon, some of them not far distant from the property in question. She then decided that it would be a mistake to proceed with any plans to build an apartment house on that site, since the other projected apartment houses were more than sufficient to satisfy the demand and there would be difficulty in securing tenants at profitable rental rates.

She then erected on the property a 12-room residence costing in excess of $90,000. On the advice of her real estate agent, this residence was constructed with three separate wings, each of which could be made into a separate apartment with its own private entrance and driveway, so that the building could be converted into a 3-family dwelling. She knew at that time that it could not be rented at a profit as a private residence. She lived in it from the time of its completion in 1926 until December 31, 1931. She then vacated it and endeavored to sell or rent it, but without success. In November or December, 1934, she discharged the caretaker whom she had left in charge of the property and turned the keys to the house over to the attorneys for the original mortgagees with the request that she be released from personal liability on the bond and mortgage. In the last week of 1934, those attorneys informed her that she would not be thus released, as the mortgagees wished to foreclose, although they expressed the opinion that there would be no deficiency judgment against the taxpayer as the mortgagees thought that the market value of the property was in excess of the amount of bond and mortgage. In the taxpayer's income tax return for the calendar year 1934 she claimed, on the basis of the foregoing, a deductible loss from gross income of $89,588.80 and also deductions for depreçiation, cost of insurance and legal expenses. The Commissioner disallowed these deductions and the Board, after hearing, sustained the deficiency as determined by the Commissioner. The taxpayer petitioned this court for review.

Taxpayer is entitled to a deduction only for a loss incurred in a "transaction entered into for profit," I.R.C. [§165(c)(2)]. The evidence amply supports the finding of the Board that there was a "definite abandonment" by the taxpayer of her original profit motive in purchasing the land and a "definite devotion of the

property to a personal residence use." The fact that the residence cost $90,000, coupled with the other facts found by the Board, answers the suggestion that the construction of the residence with three separate wings, so that it could, at some indefinite future date, be converted into three separate apartments, showed a retention of the original business purpose. That the taxpayer had in mind the possibility of later devoting the property to such a purpose is not sufficient to demonstrate that the profit motive remained dominant. Cases can be imagined where a taxpayer's motive might be mixed, with the profit motive so markedly preponderant that it should be regarded as if it were controlling. But that is not this case. Here the prospect of a future business use of the property was clearly subsidiary, only on the edge of the taxpayer's mind. Her attitude was not unlike that of the White Knight who carried a mouse-trap on his horse because, he said, "it's well to be provided for everything." At best, it was as if she had bought a residence for her personal use, intending to live in it for several years and then put it on the market.

Once the conclusion is reached that when the residence was built she did not have a business purpose, the case falls into a familiar category. There was no subsequent conversion of the property to a business use; the mere effort to rent it did not have that effect. Morgan v. Commissioner, 5 Cir., 76 F.2d 390. The claimed deductions, therefore, constituted items of personal loss and expense which are not deductible.

The judgment of the Board of Tax Appeals is affirmed.

NOTE

1. *Other cases.* For cases in which other taxpayers have been denied deductions under §165(c)(2) for houses that were used as the family's principal place of residence, notwithstanding evidence of a hope, intention, or plan at the time of acquisition of selling the property at a profit, see Austin v. Commissioner, 298 F.2d 583 (2d Cir. 1962) (occupancy found by Tax Court to be primary purpose of acquisition; sale at a profit, secondary); Wilkes v. Commissioner, 17 T.C. 865 (1951) ("clear and convincing evidence" required to overcome the "strong presumption" that property occupied by the taxpayer as a personal residence was acquired for that purpose, rather than in a transaction entered into for profit). In Randall v. Commissioner, 27 B.T.A. 475 (1932), where a deduction under §165(c)(2) was allowed, the taxpayer's occupancy of the residence was temporary and may have been primarily intended to facilitate a sale.

If a taxpayer sells or surrenders a life insurance policy on his own life for less than the aggregate premiums paid by him, does he thereby incur a deductible loss from a "transaction entered into for profit"? See London Shoe Co. v. Commissioner, 80 F.2d 230 (2d Cir.), cert. denied, 298 U.S. 663 (1935); Early v. Atkinson, 175 F.2d 118 (4th Cir. 1949).

2. *Conversion of personal property to a business or profit-seeking purpose.* With respect to a possible "subsequent conversion of the property to a business use," the Supreme Court in Heiner v. Tindle, 276 U.S. 582, 587 (1928), permitted the taxpayer to deduct under §165(c)(2) his loss on the sale of a building constructed and used for a time as a residence but subsequently rented for some years:

> The loss here has resulted from the sale of property not used for residential purposes by the taxpayer, and the transaction entered into for profit and resulting in the loss was not the purchase of the property but its appropriation to rental purposes.

The courts have regularly refused (as in the *Gevirtz* case) to accept the mere listing of the property for rental as a sufficient conversion to satisfy §165(c)(2); it must be actually rented or remodeled for rental. See, for example, Rumsey v. Commissioner, 82 F.2d 158, 159-160 (2d Cir. 1936):

> The taxpayer argues with considerable persuasive force that the fact that a man first rents his house before selling it is only significant as evidentiary of his purpose

to abandon it as a residence and to devote the property to business uses; that renting is not the sole criterion of such purpose, as the regulations themselves imply by the words "rented or otherwise appropriated" to income producing purposes. But we think the argument cannot prevail over counter considerations. If an owner rents, his decision is irrevocable, at least for the term of the lease; and if he remodels to fit the building for business purposes, he has likewise made it impossible to resume residential uses by a mere change of mind. When, however, he only instructs an agent to sell or rent the property, its change of character remains subject to his unfettered will; he may revoke the agency at any moment. Certainly it strains the language of Article 171, Regulations 74 [now Regulations §1.165-3(b)], to find that the property is "appropriated to" and "used for" income producing purposes by merely listing it with a broker for sale or rental. Until instructed by the Supreme Court that its decision in Heiner v. Tindle was intended to have a broader application, we feel constrained to follow the more natural meaning of the regulation.

In Schmidlapp v. Commissioner, 96 F.2d 680, 682 (2d Cir. 1938), Judge L. Hand wrote:

As a new matter something may no doubt be said against distinguishing between a house actually let, and one unsuccessfully put upon the market; putting the property in the hands of a broker might perhaps be regarded as itself the inception of a "transaction entered into for profit." But Morgan v. Commissioner, 5 Cir., 76 F.2d 390, and Rumsey v. Commissioner, 2 Cir., 82 F.2d 158, are the other way; they hold in effect that only an actual letting creates a "transaction," and it is true that only then does it become impossible for the owner to resume his original occupation.

In the *Gevirtz* case, the maintenance expenses and depreciation for 1934 were put on the same footing as the loss on sale of the house; all were disallowed. After the enactment in 1942 of what are now §§212 and 167(a)(2), it was held that listing a residence for rent is a sufficient conversion to permit maintenance expenses and depreciation to be deducted under §§212 and 167(a)(2), even though it is not a sufficient conversion to permit the deduction of a loss on its sale under §165(c)(2). The theory is that once the house is listed for rental, it is "held for the production of income" within the meaning of §§212 and 167(a)(2), even though there is no "transaction entered into for profit," the term used in §165(c)(2). Robinson v. Commissioner, 2 T.C. 305, 308-309 (1943); see also Horrmann v. Commissioner, 17 T.C. 903 (1951). Is listing it for *sale* sufficient? The Tax Court has divided on this question, the majority holding that listing for sale is not enough. Leslie v. Commissioner, 6 T.C. 488 (1946). In May v. Commissioner, 299 F.2d 725 (4th Cir. 1962), listing an ocean-going yacht for sale was held an insufficient conversion to permit depreciation and maintenance expenses to be deducted; the court thought that "even stouter evidence of conversion is demanded" for property with "the unique qualities of a pleasure boat" (the ease with which the owner can return to the bridge?) than for a residence.

See generally Swanson, Loss on the Sale of Residential Property, 33 Taxes 589 (1955); Roehner and Roehner, Loss Deduction on the Sale of an Abandoned Residence: Case-Law Thinking in Statutory Interpretation, 23 Fordham L. Rev. 196 (1954).

3. *Measuring the loss on property converted to business use.* If the taxpayer succeeds in establishing that the property has been converted to a business use, how is his §165(c)(2) loss to be measured? See §165(b), interpreted by Regs. §1.165-9(b) to permit the taxpayer to deduct the difference between (a) the cost of the property or its value when converted, whichever is lower, minus depreciation for the rental period, and (b) the amount realized on the sale. This means that a decline in value attributable to the period of personal use is not deductible. Compare the method of determining the taxpayer's casualty loss when personal property is damaged or destroyed, supra page 195; see also Parsons v. United States, 227 F.2d 437 (3d Cir. 1955).

For the computation of loss on property that is used simultaneously for personal and business purposes (e.g., a physician's automobile, or his home if part is used as an office), see Sharp v. United States, 199 F. Supp. 743 (D. Del. 1961), aff'd per curiam, 303 F.2d 783 (3d Cir. 1962).

4. *Property acquired by gift or inheritance.* If the taxpayer acquires a residence by gift

or inheritance, has there been "a transaction entered into for profit" so that he may take a deduction under §165(c)(2) if he sells it at a loss? Apparently an heir's decision to sell property is sufficient for §165(c)(2), even though the property was not so held by the decedent; moreover, it has been held that listing the property for rental is enough, so long as the heir has not used it as a residence himself. Williams, Executor v. Commissioner, 1 B.T.A. 1101 (1925); Crawford v. Commissioner, 16 T.C. 678 (1951); see Horrmann v. Commissioner, 17 T.C. 903, 909-910 (1951). In another case, the disposition of property by an executor was held (by a divided court) to be a "transaction entered into for profit," although the decedent had acquired it for personal reasons and would have been unable to claim a loss had he disposed of it during his lifetime. Waterman's Estate v. Commissioner, 195 F.2d 244 (2d Cir. 1952). On the other hand, a donee of investment property was held to be entitled to deduct a loss on its sale on the theory that his donor's profit-seeking purpose should be imputed to him. Tanzer v. Commissioner, 37 B.T.A. 244 (1938). The reasoning of the court is somewhat weakened by a subsequent statutory change. Could the donee alternatively assert that his own holding of the property for the production of income would constitute a "transaction entered into for profit"?

5. *Sale for tax purposes.* Is §165(c)(2) satisfied if the taxpayer incurs the loss by selling the property for tax purposes? In Terry v. United States, 10 F. Supp. 183 (D. Conn. 1934), it was held that the loss qualified so long as the property was *acquired* in a "transaction entered into for profit." If the *sale* itself had to be such a transaction, the court argued, no loss would qualify under §165(c)(2). But the sale must be bona fide and at arm's length; see Evans v. Rothensies, 114 F.2d 958, 962 (3d Cir. 1940), holding that property acquired for profit-making purposes will not give rise to a deductible loss if sold at an unnecessarily low price: "The disposition of property as well as its acquisition is material to the question whether the transaction was entered into for profit. . . ." On the other hand, a sale below market value, if dictated by business considerations (e.g., granting a proprietary interest in a business to its employees), may give rise to a §165(c)(2) deduction. Kress v. Stanton, 98 F. Supp. 470 (W.D. Pa. 1951), aff'd per curiam, 196 F.2d 499 (3d Cir. 1952).

b. EXPENSE OR INVESTMENT?

MIDLAND EMPIRE PACKING CO. v. COMMISSIONER
14 T.C. 635 (1950)

ARUNDELL, JUDGE: The issue in this case is whether an expenditure for a concrete lining in petitioner's basement to oilproof it against an oil nuisance created by a neighboring refinery is deductible as an ordinary and necessary expense under [§162(a)] of the Internal Revenue Code, on the theory it was an expenditure for a repair, or, in the alternative, whether the expenditure may be treated as the measure of the loss sustained during the taxable year and not compensated for by insurance or otherwise within the meaning of [§165(a)] of the Internal Revenue Code.

The respondent has contended, in part, that the expenditure is for a capital improvement and should be recovered through depreciation charges and is, therefore, not deductible as an ordinary and necessary business expense or as a loss.

It is none too easy to determine on which side of the line certain expenditures fall so that they may be accorded their proper treatment for tax purposes. Treasury Regulations [§1.162-4] is helpful in distinguishing between an expenditure to be classed as a repair and one to be treated as a capital outlay. In Illinois Merchants Trust Co., Executor, 4 B.T.A. 103, at page 106, we discussed this subject in some detail and in our opinion said:

It will be noted that the first sentence of the article [now, with minor changes, Regs. §1.162-4] relates to repairs, while the second sentence deals in effect with replacements.

In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

It will be seen from our findings of fact that for some 25 years prior to the taxable year petitioner had used the basement rooms of its plant as a place for the curing of hams and bacon and for the storage of meat and hides. The basement had been entirely satisfactory for this purpose over the entire period in spite of the fact that there was some seepage of water into the rooms from time to time. In the taxable year it was found that not only water, but oil, was seeping through the concrete walls of the basement of the packing plant and, while the water would soon drain out, the oil would not, and there was left on the basement floor a thick scum of oil which gave off a strong odor that permeated the air of the entire plant, and the fumes from the oil created a fire hazard. It appears that the oil which came from a nearby refinery had also gotten into the water wells which served to furnish water for petitioner's plant, and as a result of this whole condition the Federal meat inspectors advised petitioner that it must discontinue the use of the water from the wells and oil-proof the basement, or else shut down its plant.

To meet this situation, petitioner during the taxable year undertook steps to oil-proof the basement by adding a concrete lining to the walls from the floor to a height of about four feet and also added concrete to the floor of the basement. It is the cost of this work which it seeks to deduct as a repair. The basement was not enlarged by this work, nor did the oilproofing serve to make it more desirable for the purpose for which it had been used through the years prior to the time that the oil nuisance had occurred. The evidence is that the expenditure did not add to the value or prolong the expected life of the property over what they were before the event occurred which made the repairs necessary. It is true that after the work was done the seepage of water, as well as oil, was stopped, but, as already stated, the presence of the water had never been found objectionable. The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used.

While it is conceded on brief that the expenditure was "necessary," respondent contends that the encroachment of the oil nuisance on petitioner's property was not an "ordinary" expense in petitioner's particular business. But the fact that petitioner had not theretofore been called upon to make a similar expenditure to prevent damage and disaster to its property does not remove that expense from the classification of "ordinary" for, as stated in Welch v. Helvering [infra p. 228]:

ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. . . . [T]he expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. Kornhauser v. United States, 276 U.S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part.

Steps to protect a business building from the seepage of oil from a nearby refinery, which had been erected long subsequent to the time petitioner started to operate

its plant, would seem to us to be a normal thing to do, and in certain sections of the country it must be a common experience to protect one's property from the seepage of oil. Expenditures to accomplish this result are likewise normal.

In American Bemberg Corporation, 10 T.C. 361, we allowed as deductions, on the ground that they were ordinary and necessary expenses, extensive expenditures made to prevent disaster, although the repairs were of a type which had never been needed before and were unlikely to recur. In that case the taxpayer, to stop cave-ins of soil which were threatening destruction of its manufacturing plant, hired an engineering firm which drilled to the bedrock and injected grout to fill the cavities where practicable, and made incidental replacements and repairs, including tightening of the fluid carriers. In two successive years the taxpayer expended $734,316.76 and $199,154.33, respectively for such drilling and grouting and $153,474.20 and $79,687.29, respectively, for capital replacements. We found that the cost [of the drilling and grouting] did not make good the depreciation previously allowed, and stated in our opinion:

> In connection with the purpose of the work, the . . . program was intended to avert a plant-wide disaster and avoid forced abandonment of the plant. The purpose was not to improve, better, extend or increase the original plant, nor to prolong its original useful life. Its continued operation was endangered; the purpose of the expenditures was to enable petitioner to continue the plant in operation not on any new or better scale, but on the same scale and, so far as possible, as efficiently as it had operated before. The purpose was not to rebuild or replace the plant in whole or in part, but to keep the same plant as it was and where it was.

The petitioner here made the repairs in question in order that it might continue to operate its plant. Not only was there danger of fire from the oil and fumes, but the presence of the oil led the Federal meat inspectors to declare the basement an unsuitable place for the purpose for which it had been used for a quarter of a century. After the expenditures were made, the plant did not operate on a changed or larger scale, nor was it thereafter suitable for new or additional uses. The expenditure served only to permit petitioner to continue the use of the plant, and particularly the basement for its normal operations.

In our opinion, the expenditure of $4,868.81 for lining the basement walls and floor was essentially a repair and, as such, it is deductible as an ordinary and necessary business expense. This holding makes unnecessary a consideration of petitioner's alternative contention that the expenditure is deductible as a business loss. . . .

NOTE

1. *Non-deductibility of capital expenditures: §263.* Section 263 provides that deductions may not be taken for amounts "paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate" or "expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made." Do these prohibitions narrow the reach that §162 or §165 would have if §263 were repealed?

2. *Other repair vs. investment cases.* With the *Midland Empire Packing Co.* case, compare the following:

> We do not agree that the installation of the sprinkler system [in a hotel] constituted a repair made "for the purpose of keeping the property in an ordinarily efficient operating condition." Cf. Illinois Merchants Trust Co., 4 B.T.A. 103, 106, cited by petitioner. It was a permanent addition to the property ordered by the city of New York to give the property additional protection from the hazard of fire. It was an improvement or betterment having a life extending beyond the year in which it was

> made and which depreciates over a period of years. While it may not have increased the value of the hotel property or prolonged its useful life, the property became more valuable for use in the petitioner's business by reason of compliance with the city's order. The respondent did not err in determining that the cost of this improvement or betterment should be added to petitioner's capital investment in the building, and recovered through depreciation deductions in the years of its useful life. [Hotel Sulgrave, Inc. v. Commissioner, 21 T.C. 619, 621 (1954).]

See also Mt. Morris Drive-in Theatre Co. v. Commissioner, 238 F.2d 85 (6th Cir. 1956) (drainage system installed by taxpayer, after threat of litigation by adjacent landowner, must be capitalized, one judge dissenting); United States v. Times-Mirror Co., 231 F.2d 876 (9th Cir. 1956) (cost of microfilming a set of back issues as protection against loss by enemy bombing deductible; amount spent allowed "business to be operated on the same scale and not to increase," one judge dissenting); Jones v. Commissioner, 242 F.2d 616 (5th Cir. 1957) (taxpayer who reconstructed decrepit building in French Quarter of New Orleans because he could not get permission to raze it required to capitalize costs of general rehabilitation).

3. *Repairs following a casualty loss.* The taxpayer in *Midland Empire Packing Co.* made a claim against the oil refinery for the damage caused by the seepage of oil into its building; after protracted negotiations, a suit was filed, and the taxpayer was paid about $11,700 in settlement of its claim, three years after the taxable year in which the repair expenditures were incurred. A portion of this amount was included in income for the year of the settlement, but the findings of fact in the Tax Court do not disclose how the amount included in income was computed, nor whether the return was accepted as filed. If the taxpayer had known when the expenditures were incurred that they would be reimbursed, would a deduction under §162 have been warranted?

If the taxpayer's business property is damaged by fire or storm, and the loss is not covered by insurance, is he entitled both to a casualty loss deduction and to a deduction for the cost of repairing the damage? See Regs. §1.161-1 ("Double deductions are not permitted.") Would the cost of making good the damage be a capital investment under the criteria employed in the *Midland Empire Packing Co.* case?

4. *Demolition losses.* If a taxpayer purchases real property with the intention of demolishing a building and erecting a new one, does he suffer a loss that is deductible under §165 (or incur an expense under §162 or §212) equal to the amount paid for the old building? See Regs. §1.165-3.

5. *References.* Cook, Repairs Expense Versus Capital Expenditures, 13 Tax L. Rev. 231 (1958); Shugerman, Basic Criteria for Distinguishing Revenue Charges from Capital Expenditures in Income Tax Computations, 49 Mich. L. Rev. 213 (1950).

STARR'S ESTATE v. COMMISSIONER

274 F.2d 294 (9th Cir. 1959)

Before CHAMBERS, HAMELY and JERTBERG, Circuit Judges.

CHAMBERS, Circuit Judge.

Yesterday's equities in personal property seem to have become today's leases. This has been generated not a little by the circumstance that one who leases as a lessee usually has less trouble with the federal tax collector. At least taxpayers think so.

But the lease still can go too far and get one into tax trouble. While according to state law the instrument will probably be taken (with the consequent legal incidents) by the name the parties give it, the internal revenue service is not always bound and can often recast it according to what the service may consider the practical realities. We have so held in Oesterreich v. Commissioner, 9 Cir., 226 F.2d 798, and Commissioner of Internal Revenue v. Wilshire Holding Corporation, 9 Cir., 244 F.2d 904, certiorari denied 355 U.S. 815. The principal case concerns a fire sprinkler system installed at the taxpayer's plant at Monrovia, Cali-

alty had not been exhausted as in *Starr's* case. And there was no basis for inferring that Western would just keep the equipment for what it had paid. It appears that Western paid substantial amounts to acquire the equipment at the end of the term. There was just one compelling circumstance against Western in its case: What it had paid as "rent" was apparently always taken into full account in computing the end purchase price. But on the other hand, there was almost a certainty that the "lessor" would come after his property if the purchase was not eventually made for a substantial amount. This was not even much of a possibility in *Oesterreich* and not a probability in *Starr's* case.

In Wilshire Holding Corporation v. Commissioner, 9 Cir., 262 F.2d 51, we referred the case back to the tax court to consider interest as a deductible item for the lessee. We think it is clearly called for here. Two yardsticks are present. The first is found in that the normal selling price of the system was $4,960 while the total rental payments for five years were $6,200. The difference could be regarded as interest for the five years on an amortized basis. The second measure is in clause 16 (loss by fire), where the figure of six per cent per annum discount is used. An allowance might be made on either basis, division of the difference (for the five years) between "rental payments" and "normal purchase price" of $1,240, or six per cent per annum on the normal purchase price of $4,960, converting the annual payments into amortization. We do not believe that the "lessee" should suffer the pains of a loss for what really was paid for the use of another's money, even though for tax purposes his lease collapses.

We do not criticize the commissioner. It is his duty to collect the revenue and it is a tough one. If he resolves all questions in favor of the taxpayers, we soon would have little revenue. However, we do suggest that after he has made allowance for depreciation, which he concedes, and an allowance for interest, the attack on many of the "leases" may not be worth while in terms of revenue.

Decision reversed for proceedings consistent herewith.

NOTE

1. *The statutory language of §162(a)(3).* If the only authority for the deduction of rental payments were the general language of §162(a) ("ordinary and necessary expenses . . . in carrying on any trade or business"), would the taxpayer's right to a deduction be broader or narrower than under the specific language of §162(a)(3)?

Other aspects of the rental-with-option-to-purchase include the "lessor's" obligation to treat the "lease" as a taxable sale of the property. See page 441 infra; Rev. Rul. 60-122, 1960-1 C.B. 56; Rev. Rul. 55-540, 1955-2 C.B. 39.

2. *Reference.* Kirby, Considerations in Business Lease Arrangements, 34 Taxes 34 (1956).

HOCHSCHILD v. COMMISSIONER

161 F.2d 817 (2d Cir. 1947)

Before SWAN, CHASE and FRANK, Circuit Judges.

CHASE, Circuit Judge.

In his income tax return for the calendar year 1939 the petitioner deducted $4,125 which he had paid in that year as attorney's fees incurred in the successful defense of a stockholder's derivative suit brought against him and others in the state court in New York. The Commissioner disallowed the deduction in full. The Tax Court disallowed the deduction in part and this petition was brought to review that decision.

The pertinent facts were not disputed and were found in accordance with a stipulation filed by the parties. They are that the petitioner has been a director

fornia, where Delano T. Starr, now deceased, did business as the Gross Manufacturing Company. The "lessor" was Automatic Sprinklers of the Pacific, Inc., a California corporation. The instrument entitled "Lease Form of Contract" (hereafter "contract") is just about perfectly couched in terms of a lease for five years with annual rentals of $1,240. But it is the last paragraph thereof, providing for nominal rental for five years, that has caused the trouble. It reads as follows:

28. At the termination of the period of this lease, if Lessee has faithfully performed all of the terms and conditions required of it under this lease, it shall have the privilege of renewing this lease for an additional period of five years at a rental of $32.00 per year. If lessee does not elect to renew this lease, then the Lessor is hereby granted the period of six months in which to remove the system from the premises of the Lessee.

Obviously, one renewal for a period of five years is provided at $32.00 per year, if Starr so desired. Note, though, that the paragraph is silent as to status of the system beginning with the eleventh year. Likewise the whole contract is similarly silent.

The tax court sustained the commissioner of internal revenue, holding that the five payments of $1,240, or the total of $6,200, were capital expenditures and not pure deductible rental. Depreciation of $269.60 was allowed for each year. Generally, we agree.

Taxpayers took the deduction as a rental expense under trade or business pursuant to [§162(a)].

The law in this field for this circuit is established in Oesterreich v. Commissioner, supra, and Robinson v. Elliot, 9 Cir., 262 F.2d 383. There we held that for tax purposes form can be disregarded for substance and, where the foreordained practical effect of the rent is to produce title eventually, the rental agreement can be treated as a sale.

In this, *Starr's* case, we do have the troublesome circumstance that the contract does not by its terms ever pass title to the system to the "lessee." Most sprinkler systems have to be tailor-made for a specific piece of property and, if removal is required, the salvageable value is negligible. Also, it stretches credulity to believe that the "lessor" ever intended to or would "come after" the system. And the "lessee" would be an exceedingly careless businessman who would enter into such contract with the practical possibility that the "lessor" would reclaim the installation. He could have believed only that he was getting the system for the rental money. And we think the commissioner was entitled to take into consideration the practical effect rather than the legal, especially when there was a record that on other such installations the "lessor," after the term of the lease was over, had not reclaimed from those who had met their agreed payments. It is obvious that the nominal rental payments after five years of $32.00 per year were just a service charge for inspection.*

Recently the Court of Appeals for the Eighth Circuit has decided Western Contracting Corporation v. Commissioner, 1959, 271 F.2d 694, reversing the tax court in its determination that the commissioner could convert leases of contractor's equipment into installment purchases of heavy equipment. The taxpayer believes that case strongly supports him here. We think not.

There are a number of facts there which make a difference. For example, in the contracts of Western there is no evidence that the payments on the substituted basis of rent would produce for the "lessor" the equivalent of his normal sales price plus interest. There was no right to acquire for a nominal amount at the end of the term as in *Oesterreich* and the value to the "lessor" in the person-

* The "lessor" was obligated to inspect the system at least once annually and to replace defective parts. — Ed.

and substantial stockholder of The American Metal Company, Ltd., a New York corporation, from November 22, 1916 to at least the date of the beginning of the proceedings in the Tax Court and, since May 24, 1917 has also been one of its principal officers. In accordance with a long standing practice of The American Metal Company its directors, officers, stockholders and employees were permitted to participate in new ventures which it undertook. A syndicate, formed in November 1916 consisting of The American Metal Company and a number of its directors, officers, employees and stockholders, acquired an option upon certain molybdenum properties at Climax, Col. The option was exercised and a Delaware corporation called Climax Molybdenum Company was organized in January 1917 to which the syndicate's property was transferred in consideration for its capital stock and the petitioner then became a stockholder of Climax in proportion to his interest in the syndicate. He has remained a stockholder and has been a director and part of the time an officer of Climax at least up to the commencement of the proceedings below.

The Climax venture at length proved to be a financial success and in December 1938 a stockholder's derivative suit was brought in the New York Supreme Court, New York County, against the petitioner and others for the benefit of The American Metal Company in which the petitioner and others were charged with breaches of their fiduciary duties to the Metal Company in respect to the Climax venture. It was consolidated for trial with a similar suit thereafter commenced in the same court. The petitioner was partly successful in defending that suit in the trial court, 36 N.Y.S.2d 356, and upon appeal a judgment of the Appellate Division of the Supreme Court, 50 N.Y.S.2d 800, which became final, completely vindicated him.

The plaintiffs in the above mentioned suit sought, inter alia, (1) to impress a trust upon the Climax stock held by the petitioner; (2) an accounting for damages and profits; and (3) an accounting for the value of any shares of Climax which the petitioner had held but was unable to transfer to The American Metal Company by reason of his sale or other disposition of them.

The petitioner had acquired 1,500 shares of Climax stock in 1918, 1,500 additional shares in 1920-21 and had surrendered 321 of them in 1926 in the settlement of litigation between Climax and the Metal Company. The Climax stock was split 10 for one in 1929 and three for one in 1935. During the period 1933 to 1939 inclusive the petitioner received dividends on his Climax stock amounting in the aggregate to $1,281,331.95.

The attorney's fees which the petitioner paid in making his successful defense of the suit in the state court were claimed to be deductible under [§162(a)] of the Internal Revenue Code, as ordinary and necessary expenses paid during the taxable year in carrying on a trade or business and, in the alternative, under [§212] of the Code as necessary expenses paid during the taxable year for the production or collection of income, or for the management, conservation, or maintenance of property held for the production of income.

The Tax Court allocated $3,581.84 of the fees paid to the expense of defending the equitable title to the petitioner's Climax stock and held that part of it was not deductible because it was the cost of defending the title to property and thus a capital expenditure within Regs. [§1.263(a)-2(c)]. The remainder was allowed as a deduction on the ground that it was paid to retain income after it was collected and was to be treated for purposes of deduction as though paid for the collection of the income. In this the Commissioner acquiesced. . . .

The petitioner when acting as a director and officer of The American Metal Company was engaged in carrying on a trade or business within the meaning of the above statute. Commissioner v. People's-Pittsburgh Trust Co., 3 Cir., 60 F.2d

187; Foss v. Commissioner, 2 Cir., 75 F.2d 326. The fees paid were ordinary and necessary expenses which were directly connected with such business, being paid to defend a lawsuit in which he was charged with breaches of the fiduciary duties he owed the corporation he served as a director and officer. Commissioner v. Heininger, 320 U.S. 467; Welch v. Helvering, 290 U.S. 111, 54; Kornhauser v. United States, 276 U.S. 145. He owed the corporation no duty as a fiduciary merely because he was a stockholder; his liability so alleged being solely that of a malfeasant director and officer and on that decision turned. The significance of his status as a stockholder is limited to the fact that, had the breaches of fiduciary duties been established, the state court would have had the opportunity as well as the power to deprive him of the Climax stock he still held and not have had to confine its relief to money damages.

Regardless of what effect an adverse decision might have had upon the title to his Climax stock, it was necessary for him to defend the lawsuit to protect himself from being compelled to account generally for the alleged breaches of the duties to The American Metal Company. And all the ordinary and necessary expenses which he paid in the taxable year for such defense were deductible under [§162(a)] of the Code as it has been construed in the authorities above cited.

We cannot agree that these fees which the petitioner paid in defense of the lawsuit were any the less deductible because his liability, if proved, might have destroyed his equitable title to the stock he held. His right to keep it was certainly in issue and in that sense his title to it was defended, to be sure, but the title as such was not perfected in any way by his expenditures for legal assistance. He thereby but fended off an abortive attack upon the conduct of his business as a fiduciary and by freeing himself from liability to his corporation to account for such conduct put all of his property beyond the reach of his then accusers. . . .

Decision reversed.

FRANK, Circuit Judge (dissenting in part).

To explain my reasons for partially dissenting, I must supplement my colleagues' statement of facts. The complaint in the State court suit, Turner v. American Metal Company (expressly made part of the stipulation on which the instant case was tried in the Tax Court), charged that, as a result of a conspiracy in which taxpayer and other officers and directors of American Metal had joined, the following had occurred: (a) Taxpayer had himself wrongfully acquired title to certain shares of the Climax Company, and the equitable title to those shares was therefore in American Metal. (b) Taxpayer had aided others in wrongfully acquiring title to certain other Climax shares; some of those others were direct parties to the conspiracy, while still others acquired such shares with full knowledge of the conspiracy; the equitable title to all these shares was asserted to be in American Metal. (c) Taxpayer had aided in causing American Metal wrongfully to spend money for the benefit of Climax, to the damage of American Metal. On this basis, the *Turner* complaint prayed as follows: (a) That taxpayer be ordered to transfer to American Metal the legal title to the Climax shares which he had wrongfully obtained; (b) that he account for any dividends on those Climax shares;[1] (c) that he and the other conspirators be held liable, jointly and severally, for all damages to American Metal resulting from the conspiracy. I think that these facts call for a nicer analysis than that contained in my colleague's opinion, for the following reasons:

1. In part, the *Turner* suit sought to hold taxpayer liable merely for damages said to have resulted from his conduct as an official of American Metal. Here I

[1] As to expenses incurred in defending as to this item, the Tax Court decided in favor of taxpayer, and the Commissioner has not appealed.

refer to (a) the alleged damages resulting from the moneys said to have been wrongfully paid by American Metal for the benefit of Climax, and (b) the alleged damages to American Metal resulting from the fact that the taxpayer and his alleged co-conspirators aided others than himself in allegedly wrongful acquisition of Climax stock.[2] To that extent, I agree that, in the *Turner* suit, he was not defending the title to the Climax stock he held or to any other of his property. To rule otherwise would be to say that defense of any suit is a defense against an attack on title to property, since an adverse judgment (through levy of execution or otherwise) may diminish a defendant's property, including, for instance, stock in which he may have invested. Consequently, taxpayer's expense in defending that phase of the *Turner* suit was, I think, incurred as a result of "carrying on a trade or business." Up to that point, in line with the authorities cited by them, I agree with my colleagues.

2. I think, however, that the same is not true of his defense of that part of the *Turner* suit which charged him with having himself wrongfully obtained Climax shares and which sought an order directing him to transfer those shares to American Metal as its equitable owner. To that extent, the *Turner* action was a direct attack on his title to the Climax shares.

True, that attack was grounded on the alleged impropriety of his conduct as an American Metal official, coupled with alleged similar improper conduct by other such officials conspiring with him; for the theory of the *Turner* suit was that only by such conduct had it been possible for him to acquire the Climax shares. But, in that respect, the action was the same as if, not being himself an American Metal officer, taxpayer had obtained Climax stock through action of American Metal officers known to him to be violative of their corporate obligations; in those circumstances, his expense of defending a suit seeking to compel him to transfer the title to such stock to American Metal, as its equitable owner, would not have been incurred in "carrying on a trade or business." So it seems to me that this follows: That, in order to succeed in having taxpayer ordered to transfer his Climax stock to American Metal, Turner had to prove that taxpayer's acquisition of that stock, for his own benefit, had been made possible by taxpayer's misconduct as an American Metal official, does not alter the fact that the *Turner* suit, as to those shares, was a direct attack on taxpayer's title to that stock. In other words, I think it immaterial that the alleged defect in that title stemmed from taxpayer's own alleged deviation from his corporate duties. Wherefore, in defending this phase of the action, taxpayer, I think, was engaged directly in protecting his title to property. . . .

However, taxpayer was, even as to [this] phase of the *Turner* suit, also in part defending the way he had functioned as a corporate officer. That part of the expense was, I believe, deductible.

3. Taxpayer made no proof of the appropriate allocation of the expenses as between the items discussed above. Since he had the burden, perhaps, if the foregoing is correct, he should fail. But I think that, in accordance with the doctrine of Cohan v. Commissioner, 2 Cir., 39 F.2d 540, 543-545, we should remand for determination of the allocation by the Tax Court.

NOTE

1. *Capital outlays and §212.* Bowers v. Lumpkin, 140 F.2d 927, 929 (4th Cir. 1944), involved the deductibility under §212 of legal expenses incurred by the taxpayer in the successful defense of a suit to invalidate a purchase by her of stock from trustees for a

2 There would be no such damages if those others still have the shares and were thus able to transfer them to American Metal.

charity. The taxpayer argued that even though such expenses might not be deductible under §162(a) by a person in trade or business, they were deductible under §212:

> It is contended that the phrase "all the ordinary and necessary expenses" in the amendment [§212] covers more ground than it did in the original act [§162(a)] because the amendment expressly authorizes a deduction for expenses paid "for the management, conservation, or maintenance of property held for the production of income"; and the word "conservation" is said to be particularly pertinent in the pending case where the expenses were incurred in the protection of income producing stock from adverse attack.

But the court, holding that the phrase "ordinary and necessary expenses" in §212 must be interpreted in the light of its settled meaning under §162(a), denied the deduction. See further Garrett v. Crenshaw, 196 F.2d 185 (4th Cir. 1952), and Allen v. Selig, 200 F.2d 487 (5th Cir. 1952). May the taxpayer add such expenditures to the basis of the stock in computing gain or loss when it is sold?

In Sergievsky v. McNamara, 135 F. Supp. 233 (S.D.N.Y. 1955), Mr. Hochschild's sister, who was also a defendant in the *Turner* suit but not an officer or director of the corporation, was allowed to deduct her share of the cost of defending under §212. She had acquired her shares as legatee of her father, who had allegedly violated a fiduciary duty to the corporation. The court held that the expenses were incurred to conserve income-producing property, within the meaning of §212, not to defend her title.

2. *Legal expenses of plaintiff in shareholder's action.* Are the legal expenses of the plaintiff in a derivative shareholder's action (like the one brought against the taxpayer in the *Hochschild* case) deductible under §212, or a proper addition to the basis of his shares? In Surasky v. United States, 325 F.2d 191 (5th Cir. 1963), the court held that a shareholder of Montgomery, Ward & Company who made a contribution to the "Wolfson Committee" to finance a proxy fight against the company's management could deduct the payment under §212; see also Graham v. Commissioner, 326 F.2d 878 (4th Cir. 1964).

3. *References.* Brookes, Litigation Expenses and the Income Tax, 12 Tax L. Rev. 241 (1957); McDonald, Deduction of Attorneys' Fees for Federal Income Tax Purposes, 103 U. of Pa. L. Rev. 168 (1954); Note, Proxy Fight Expenses: Problems of Tax Deduction, 43 Va. L. Rev. 891 (1957).

WELCH v. HELVERING
290 U.S. 111 (1933)

MR. JUSTICE CARDOZO delivered the opinion of the Court.

The question to be determined is whether payments by a taxpayer, who is in business as a commission agent, are allowable deductions in the computation of his income if made to the creditors of a bankrupt corporation in an endeavor to strengthen his own standing and credit.

In 1922 petitioner was the secretary of the E. L. Welch Company, a Minnesota corporation, engaged in the grain business. The company was adjudged an involuntary bankrupt, and had a discharge from its debts. Thereafter the petitioner made a contract with the Kellogg Company to purchase grain for it on a commission. In order to re-establish his relations with customers whom he had known when acting for the Welch Company and to solidify his credit and standing, he decided to pay the debts of the Welch business so far as he was able. In fulfillment of that resolve, he made payments of substantial amounts during five successive years. In 1924, the commissions were $18,028.20, the payments $3,975.97; in 1925, the commissions $31,377.07, the payments $11,968.20; in 1926, the commissions $20,925.25, the payments $12,815.72; in 1927, the commissions $22,119.61, the payments $7,379.72; and in 1928, the commissions $26,177.56, the payments $11,068.25. The Commissioner ruled that these payments were not deductible from income as ordinary and necessary expenses, but were rather in the nature

of capital expenditures, an outlay for the development of reputation and good will. The Board of Tax Appeals sustained the action of the Commissioner (25 B.T.A. 117), and the Court of Appeals for the Eighth Circuit affirmed. 63 F.(2d) 976. The case is here on certiorari. . . .

We may asume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. McCulloch v. Maryland, 4 Wheat. 316, 4 L. Ed. 579. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. Kornhauser v. United States, 276 U.S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

The line of demarcation is now visible between the case that is here and the one supposed for illustration. We try to classify this act as ordinary or the opposite, and the norms of conduct fail us. No longer can we have recourse to any fund of business experience, to any known business practice. Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to be read in its natural and common meaning . . . we should have to say that payment in such circumstances, instead of being ordinary is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

The Commissioner of Internal Revenue resorted to that standard in assessing the petitioner's income, and found that the payments in controversy came closer to capital outlays than to ordinary and necessary expenses in the operation of a business. His ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong. . . . Unless we can say from facts within our knowledge that these are ordinary and necessary expenses according to the ways of conduct and the forms of speech prevailing in the business world, the tax must be confirmed. But nothing told us by this record or within the sphere of our judicial notice permits us to give that extension to what is ordinary and necessary. Indeed, to do so would open the door to many bizarre analogies. One man has a family name that is clouded by thefts committed by an ancestor. To add to his own standing he repays the stolen money, wiping off, it may be, his income for the year. The payment figures in his tax return as ordinary expenses. Another man conceives the notion that he will be able to

practice his vocation with greater ease and profit if he has an opportunity to enrich his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation. There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital assets, like the good will of an old partnership. Cf. Colony Coal & Coke Corp. v. Commissioner (C.C.A.) 52 F.(2d) 923. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.

Many cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them would be a futile task. They involve the appreciation of particular situations, at times with border-line conclusions. Typical illustrations are cited in the margin.[1]

The decree should be

Affirmed.

NOTE

Later cases. Somewhat similar expenses have been allowed in several cases subsequent to Welch v. Helvering on a finding that they were made to "protect" and "promote" the taxpayer's existing business, rather than to "acquire" business or goodwill. Thus, in Dunn & McCarthy, Inc. v. Commissioner, 139 F.2d 242, 244 (2d Cir. 1943), a corporation was permitted to deduct amounts it paid to certain employees who had lent funds to its former president; he had lost the money gambling at the race track and had died insolvent. The court did not think the payments were "extraordinary": "It was the kind of outlay which we believe many corporations would make, and have made, under similar circumstances." The *Welch* case was distinguished: "Welch made a capital outlay to acquire good will for a new business. In the present case the payment was an outlay to retain an existing good will, that is, to prevent loss of earnings that might result from destroying such good will by failing to recognize the company's moral obligation." In Carl Reimers Co., Inc. v. Commissioner, 19 T.C. 1235 (1953), a majority of the Tax Court betrayed some skepticism as to the validity of the distinction; in affirming, the Court of Appeals for the Second Circuit adhered to the distinction, not surprisingly in view of the fact that its own decision in the *Dunn & McCarthy* case, supra, had created it. 211 F.2d 66 (2d Cir. 1954).

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1 Ordinary expenses: Commissioner v. People's Pittsburgh Trust Co., 60 F.(2d) 187, expenses incurred in the defense of a criminal charge growing out of the business of the taxpayer; American Rolling Mill Co. v. Commissioner, 41 F.(2d) 314, contributions to a civic improvement fund by a corporation employing half of the wage earning population of the city, the payments being made, not for charity, but to add to the skill and productivity of the workmen (cf. the decisions collated in 30 Columbia Law Review, 1211, 1212, and the distinctions there drawn); Corning Glass Works v. Lucas, 37 F.(2d) 798, donations to a hospital by a corporation whose employees with their dependents made up two-thirds of the population of the city; Harris & Co. v. Lucas, 48 F.(2d) 187, payments of debts discharged in bankruptcy, but subject to be revived by force of a new promise. Cf. Lucas v. Ox Fibre Brush Co., 281 U.S. 115, where additional compensation, reasonable in amount, was allowed to the officers of a corporation for services previously rendered. Not ordinary expenses: Hubinger v. Commissioner, 36 F.(2d) 724, payments by the taxpayer for the repair of fire damage, such payments being distinguished from those for wear and tear; Lloyd v. Commissioner, 55 F.(2d) 842, counsel fees incurred by the taxpayer, the president of a corporation, in prosecuting a slander suit to protect his reputation and that of his business; One Hundred Five West Fifty-Fifth Street v. Commissioner, 42 F.(2d) 849, and Blackwell Oil & Gas Co. v. Commissioner, 60 F.(2d) 257, gratuitous payments to stockholders in settlement of disputes between them, or to assume the expense of a lawsuit in which they had been made defendants; White v. Commissioner, 61 F.(2d) 726, payments in settlement of a lawsuit against a member of a partnership, the effect being to enable him to devote his undivided efforts to the partnership business and also to protect its credit.

COUGHLIN v. COMMISSIONER

203 F.2d 307 (2d Cir. 1953)

Before AUGUSTUS N. HAND, CHASE and CLARK, Circuit Judges.

CHASE, Circuit Judge.

The petitioner has been a member of the bar for many years and in 1944 was admitted to practice before the Treasury Department. In 1946 he was in active practice in Binghamton, N.Y., as a member of a firm of lawyers there. The firm engaged in general practice but did considerable work which required at least one member to be skilled in matters pertaining to Federal taxation and to maintain such skill by keeping informed as to changes in the tax laws and the significance of pertinent court decisions when made. His partners relied on him to keep advised on that subject and he accepted that responsibility. One of the various ways in which he discharged it was by attending, in the above mentioned year, the Fifth Annual Institute on Federal Taxation which was conducted in New York City under the sponsorship of the Division of General Education of New York University. In so doing he incurred expenses for tuition, travel, board and lodging of $305, which he claimed as an allowable deduction under [§162(a)], as ordinary and necessary expenses incurred in carrying on a trade or business and no question is raised as to their reasonableness in amount. The Commission disallowed the deduction and the Tax Court, four judges dissenting, upheld the disallowance on the ground that the expenses were non-business ones "because of the educational and personal nature of the object pursued by the petitioner."

The Tax Court found that the Institute on Federal Taxation was not conducted for the benefit of those unversed in the subject [of] Federal taxation and students were warned away. In 1946, it was attended by 408 attorneys, accountants, trust officers, executives of corporations and the like. In 1947, over 1500 of such people from many states were in attendance. It was "designed by its sponsors to provide a place and atmosphere where practitioners could gather trends, thinking and developments in the field of Federal taxation from experts accomplished in that field."

Thus there is posed for solution a problem which involves no dispute as to the basic facts but is, indeed, baffling because, as is so often true of legal problems, the correct result depends upon how to give the facts the right order of importance.

We may start by noticing that the petitioner does not rely upon [§212] which permits the deduction of certain non-trade or non-business expenses, but rests entirely upon his contention that the deduction he took was allowable as an ordinary and necessary expense incurred in the practice of his profession. The expenses were deductible under [§162 (a)] if they were "directly connected with" or "proximately resulted from" the practice of his profession. Kornhauser v. United States, 276 U.S. 145, 153. And if it were usual for lawyers in practice similar to his to incur such expenses they were "ordinary." Deputy v. DuPont, 308 U.S. 488, 495. They were also "necessary" if appropriate and helpful. Welch v. Helvering, 290 U.S. 111. But this is an instance emphasizing how dim a line is drawn between expenses which are deductible because incurred in trade or business, i.e., because professional, and those which are non-deductible because personal. [§262.]

The respondent relies upon [Regs. §1.212-1(f)], which provides that "expenses of taking special courses or training" are not allowable as deductions under [§212]. But [§212] concerns non-trade or non-business expenses. It is not necessary to decide whether, in the light of the regulation, an expense of the nature here involved would be deductible if incurred in connection with a profit-making

venture that is not a trade or business. It will suffice to say that, since the expense was incurred in a trade or business within the meaning of [§162(a)], the regulation interpreting [§212] is not a bar to allowance here.

In Welch v. Helvering, 290 U.S. at page 115, there is a dictum that the cost of acquiring learning is a personal expense. But the issue decided in that case is far removed from the one involved here. There the taxpayer paid debts for which he was not legally liable whose payment enhanced his reputation for personal integrity and consequently the value of the good will of his business, and it was held that these payments were personal expenses. The general reference to the cost of education as a personal expense was made by way of illustrating the point then under decision, and it related to that knowledge which is obtained for its own sake as an addition to one's cultural background or for possible use in some work which might be started in the future. There was no indication that an exception is not to be made where the information acquired was needed for use in a lawyer's established practice.

Regulations [§1.162-6] makes clear that among the expenses which a professional man may deduct under [§162(a)] are dues to professional societies, subscriptions to professional journals, and amounts currently expended for books whose useful life is short. Such expenses as are here in question are not expressly included or excluded, but they are analogous to those above stated which are expressly characterized as allowable deductions.

This situation is closely akin to that in Hill v. Commissioner, 4 Cir., 181 F.2d 906, where the expenses incurred by a teacher in attending a summer school were held deductible. The only difference is in the degree of necessity which prompted the incurrence of the expenses. The teacher couldn't retain her position unless she complied with the requirements for the renewal of her teaching certificate: and an optional way to do that, and the one she chose, was to take courses in education at a recognized institution of learning. Here the petitioner did not need a renewal of his license to practice and it may be assumed that he could have continued as a member of his firm whether or not he kept currently informed as to the law of Federal taxation. But he was morally bound to keep so informed and did so in part by means of his attendance at this session of the Institute. It was a way well adapted to fulfill his professional duty to keep sharp the tools he actually used in his going trade or business. It may be that the knowledge he thus gained incidentally increased his fund of learning in general and, in that sense, the cost of acquiring it may have been a personal expense; but we think that the immediate, over-all professional need to incur the expenses in order to perform his work with due regard to the current status of the law so overshadows the personal aspect that it is the decisive feature.

It serves also to distinguish these expenditures from those made to acquire a capital asset. Even if in its cultural aspect knowledge should for tax purposes be considered in the nature of a capital asset as was suggested in Welch v. Helvering, supra, the rather evanescent character of that for which the petitioner spent his money deprives it of the sort of permanency such a concept embraces.

Decision reversed and cause remanded for the allowance of the deduction.

NOTE

1. *The 1958 Regulations.* For many years, the Regulations under §212 have provided, §1.212-1(f), that the taxpayer may not deduct

> expenses such as those paid or incurred in seeking employment or in placing oneself in a position to begin rendering personal services for compensation, . . . bar examination fees and other expenses paid or incurred in securing admission to the bar,

and corresponding fees and expenses paid or incurred by physicians, dentists, accountants, and other taxpayers for securing the right to practice their respective professions.

Yet paragraph (b) of the same Regulation states that the expense of maintaining a building is deductible even though no income is being currently produced and that "income," as the term is used in §212, comprehends income which the taxpayer "may realize in subsequent taxable years." Why is not a bar examination fee, for example, as much a cost of producing or collecting future income as is the cost of maintaining a presently unoccupied building? After admission to the bar, but before gaining any clients, may the young attorney deduct the salary of an idle stenographer?

If the taxpayer is already qualified to practice his occupation or profession, but incurs expenses for additional training, the relevant Regulation is Regs. §1.162-5, which was amended in 1958 after the Secretary of Health, Education, and Welfare — perhaps responding to the success of Sputnik I — wrote the Secretary of the Treasury that "the importance to the national security of encouraging teachers to employ their summers and their leaves of absence in acquiring greater mastery of their professional responsibilities leads . . . to the conclusion that the criteria which now govern the deductibility of expenses of teachers for further education should be liberalized," but without indicating whether more liberal Regulations or new legislation would be appropriate. Note the distinction in §1.162-5 between the expenses of retaining the taxpayer's salary, status, or employment and the expenses of education for a new position or substantial advancement in position. Do the new Regulations go beyond what was permitted in *Coughlin?*

The Internal Revenue Service's interpretation of the 1958 Regulation may be found in Rev. Rul. 60-97, 1960-1 C.B. 69. For the judicial response, see Sandt v. Commissioner, 303 F.2d 111 (3d Cir. 1962) (research chemist denied deduction for cost of attending law school, where primary purpose was to qualify for new post as patent chemist); Welsh v. United States, 210 F. Supp. 597 (N.D. Ohio, 1962) (law school expenses incurred by internal revenue agent; held deductible, on proof that purpose was improved skills in regular employment, despite taxpayer's entry into private law practice shortly after admission to bar); Marlor v. Commissioner, 251 F.2d 615 (2d Cir. 1958) (graduate study by college instructor on temporary appointment who could be neither reappointed nor promoted without demonstrating substantial progress toward doctoral degree; held, deductible).

On the cost of a physician's training in psychoanalysis, including the cost of his own analysis, see Watson v. Commissioner, 31 T.C. 1014 (1959) (deductible, where physician specialized in internal medicine and intended to continue to do so, using psychoanalysis only to improve his skill as an internist); Namrow v. Commissioner, 288 F.2d 648 (4th Cir. 1961) (non-deductible, by psychiatrist intending to specialize in psychoanalysis; alternative claim for deduction of cost of personal psychoanalysis as medical expense disallowed on ground taxpayer was being trained for profession, not treated for illness).

In most of the cases in which deductions have been denied, the taxpayers have been seeking to qualify for promotion or a new post. But see Davis v. Commissioner, 38 T.C. 175 (1962), denying a deduction for travel expenses incurred by a professor in connection with scholarly research, on theory that a professor with lifetime tenure has it made and can relax ; six judges dissented, and the Internal Revenue Service, on mature reflection in which Commissioner, formerly Professor, Caplin may have participated, in effect confessed error by issuing Rev. Rul. 63-275, 1963-2 C.B. 85 (research expenses, including travel, incurred by professor for purpose of teaching or writing in his area of competence are deductible under §162(a) even though he expects no compensation other than his regular salary).

In Brooks v. Commissioner, 274 F.2d 96 (9th Cir. 1959), a research scientist was allowed to deduct traveling and living expenses while engaged in (uncompensated) research in Europe. Does this suggest that the recipient of a fellowship whose grant does not specifically designate any amount for travel (supra p. 143) may deduct the portion actually expended for this purpose? Does §265(1) have any bearing on this question, if the taxpayer is availing himself of the $300 monthly exclusion of §117(b)(2)(B)?

Can a professional man take a deductible Mediterranean cruise if he listens to lectures on shipboard? Hoover v. Commissioner, 35 T.C. 566 (1961); and see the cases on business conventions, supra page 227.

The cases cited above are only a modest sample of the spate of recent litigation. One more case, the saddest tax story ever told: Gulbranson v. Commissioner, ¶63,205 P-H Memo T.C. — an employee of a law firm went to night law school, studied so much that his wife left him, flunked out despite his best efforts, and was denied a deduction because the skills he did not acquire would have qualified him for admission to the bar.

2. *References.* Loring, Some Tax Problems of Students and Scholars, 45 Calif. L. Rev. 153 (1957); Oliver, The Deductibility of Expenses: A Professor's Research and a Study in His Home, 50 A.A.U.P. Bulletin No. 1, p. 14 (1964).

FRANK v. COMMISSIONER

20 T.C. 511 (1953)

[The taxpayer, who had been employed as a newspaperman before World War II, was discharged from the navy in November, 1945. With his wife, who had been employed by several government agencies during the war, he traveled extensively in search of a newspaper or radio station to purchase and operate. For about six months in 1946, they were employed by a newspaper in Phoenix, Arizona, but continued to travel to examine other newspapers that were for sale. In November, 1946, they purchased a newspaper in Canton, Ohio, and commenced at once to publish it.]

VAN FOSSAN, Judge: The only question presented is whether the petitioners may deduct $5,965 in the determination of their net income for the year 1946 as ordinary and necessary business expenses or as losses. The petitioners base their claim for deductions upon [§162(a), §212, and §165(c)(2)]. The evidence reasonably establishes that the petitioners expended the amount of expenses stated in our Findings of Fact during the taxable year in traveling, telephone, telegraph, and legal expenses in the search for and investigation of newspaper and radio properties. This total amount was spent by the petitioners in their travels through various states in an endeavor to find a business which they could purchase and operate. These expenses do not include amounts spent while living in Phoenix, Arizona.

The travel expenses and legal fees spent in searching for a newspaper business with a view to purchasing the same cannot be deducted under the provisions of [§162(a)]. The petitioners were not engaged in any trade or business at the time the expenses were incurred. The trips made by the taxpayers from Phoenix, Arizona, were not related to the conduct of the business that they were then engaged in but were preparatory to locating a business venture of their own. The expenses of investigating and looking for a new business and trips preparatory to entering a business are not deductible as an ordinary and necessary business expense incurred in carrying on a trade or business. George C. Westervelt, 8 T.C. 1248. The word "pursuit" in the statutory phrase "in pursuit of a trade or business" is not used in the sense of "searching for" or "following after," but in the sense of "in connection with" or "in the course of" a trade or business. It presupposes an existing business with which petitioner is connected. The fact that petitioners had no established home during the period of their travels further complicates the question and alone may be fatal to petitioners' case. If they had no home, how could they have expenses "away from home"? The issue whether all or part of the expenses so incurred were capital expenditures is not raised or argued and we do not pass judgment on such question.

Neither are the travel and legal expenses incurred by the petitioners in their attempt to find and purchase a business deductible under [§212], which allows the deduction of expenses incurred in the production or collection of income or in the management, conservation, or maintenance of property held for the produc-

tion of income. There is a basic distinction between allowing deductions for the expense of producing or collecting income, in which one has an existent interest or right, and expenses incurred in an attempt to obtain income by the creation of some new interest. Marion A. Burt Beck, 15 T.C. 642, aff'd 194 F.2d 537. Stella Elkins Tyler, 6 T.C. 135. The expenses here involved are of the latter classification. The traveling costs were incurred in an endeavor to acquire a business which might, in the future, prove productive of income. It might reasonably be said that petitioners were engaged in the active search of employment as newspaper owners, but that cannot be regarded as a business. It is much like the situation obtaining in Mort L. Bixler, 5 B.T.A. 1181, or like that found in McDonald v. Commissioner, 323 U.S. 57, where it was held that a Pennsylvania court of common pleas judge seeking reelection could not deduct under [§212] expenses of such campaign. The Supreme Court said ". . . his campaign contributions were not expenses incurred in being a judge but in trying to be a judge for the next ten years."

The petitioners contend finally that the expenses in question must be allowed as deductions as nonbusiness losses under [§165(c)(2)]. This subsection of the Code provides a deduction for losses incurred in transactions entered into for profit. The only transaction entered into for profit by the petitioners, as disclosed by the facts, was the purchase of a newspaper in Canton, Ohio. Other possible transactions were investigated and rejected or otherwise not entered into. It cannot be said that the petitioners entered into a transaction every time they visited a new city and examined a new business property. Nor can we hold that petitioners entered into such transactions and then abandoned them, as they here contend. Rather, they refused to enter into such transactions after the preliminary investigation. If the general search for a suitable business property itself be considered as a transaction entered into for profit, no abandonment of such project occurred in the taxable year so as to enable deduction of these expenses as losses. Travel and legal expenses, such as were incurred here by petitioners, are not deductible as losses. Robert Lyons Hague, 24 B.T.A. 288; cf. Charles T. Parker, 1 T.C. 709. The cases cited by the petitioners concern instances where transactions were actually entered into and losses were than sustained upon abandonment. We cannot find this situation here.

We conclude that the petitioners may not deduct the expenses claimed for 1946 under the applicable provisions of the Internal Revenue Code.

NOTE

1. *A no man's land?* The expenditures allocable to the newspaper in Canton could probably have been capitalized, but could the rest of the expenditures be included in the cost basis of the Canton business? See Rev. Rul. 55-442, 1955-2 C.B. 529, implying that the cost of inspecting several sites for a boy's camp could not be added to the cost basis of the site that was finally acquired. See also Rev. Rul. 57-418, 1957-2 C.B. 143, issued in reliance on the *Frank* case, ruling that a taxpayer can deduct expenditures incurred in search of a business or investment "only where the activities are more than investigatory and the taxpayer has actually entered into a transaction for profit and the project is later abandoned." Under this ruling, a taxpayer whose investigation was totally unsuccessful would be denied a deduction under §165(c)(2) and would be equally unable to capitalize the expenditures. See also Rev. Rul. 55-237, 1955-1 C.B. 317, ruling that a taxpayer engaged in investing in independently produced motion pictures released in the United States could not deduct the expense of a trip to Europe "to explore the general possibilities of making more favorable investments in films there" because he did not possess "an existing right or interest resulting in the production of income"; Rev. Rul.

56-511, 1956-2 C.B. 170, denying a deduction for the cost of trips by an investor to attend shareholders' meetings of corporations in which he owned stock.

Do these cases and rulings create a no man's land of expenditures that are incurred for acquisitive rather than personal reasons, but that the taxpayer can neither deduct under §162(a), §165(c)(2), or §212 nor capitalize for eventual offset against income? Is this the fate of the cost of going to law or medical school or of taking an examination to acquire a professional license? Should the Code be amended so that all non-personal expenditures made for purposes of profit will be offset against income at some time?

2. *Reference*. Fleischer, The Tax Treatment of Expenses Incurred in Investigation for a Business or Capital Investment, 14 Tax L. Rev. 567 (1959).

C. WHAT IS "ORDINARY AND NECESSARY"?

FRIEDMAN v. DELANEY

171 F.2d 269 (1st Cir. 1948), cert. denied, 336 U.S. 936 (1949)

Before MAGRUDER, Chief Judge, WOODBURY, Circuit Judge, and PETERS, District Judge.

PETERS, District Judge.

In this suit the plaintiff taxpayer seeks to recover the sum of $3,411.47, the amount by which his income tax for the year 1941 was increased by reason of the refusal of the Commissioner to allow the deduction of an item of $5,000, claimed in the income tax return to be a bad debt, but now asserted to be allowable as a business expense or a loss incurred in business. There is no dispute about the facts.

It appears that the plaintiff, Mr. Friedman, a Boston lawyer of long experience, had a valued client in whom he had confidence, one Louis H. Wax, whose proposed composition in bankruptcy required the deposit in court of the sum of $7000. The record shows that Mr. Friedman made this deposit in February, 1938, accompanying it with a caveat to the effect that no part of the money came from Wax or his estate. In November, 1939, Mr. Friedman entered a petition in bankruptcy court alleging "that the money deposited for the proposed composition, which has been abandoned," was deposited by him and was not the property of the bankrupt, and asking that it be ordered returned. The petition was denied in November, 1941, and thereupon Mr. Friedman filed an undertaking that he would not further oppose transfer of the money to the trustee in bankruptcy, at the same time alleging that slightly over $5000 of the amount deposited was his own money.

It seems that the reason Mr. Friedman furnished this money from his own funds in the bankruptcy proceeding was because, in conversations with attorneys for creditors, when he was urging the acceptance of the proposed composition, he had personally assured them that the money to carry it out would be forthcoming. He did this without informing Mr. Wax and without intending to subject him to any legal liability, presumably feeling certain that the money would be obtained from a certain life insurance policy, which he had in his possession. This policy on the life of Wax, payable to his wife, could be pledged for $5000, but when it came to that point Mr. and Mrs. Wax refused to have it so used, which left Mr. Friedman in the breach. Commendably recognizing his moral obligation, in view of the assurances he had given, he paid the money to the clerk of the bankruptcy court.

The question presented is whether the $5000, which the plaintiff in his complaint alleged was "lost by him in connection with the bankruptcy proceedings

of one Louis H. Wax," and which he claimed as a deduction from income in his return for 1941, was wrongfully disallowed by the Commissioner, the plaintiff now claiming that it should have been allowed as an ordinary and necessary expense in carrying on business under [§162(a)], or a loss incurred in business under [§165(a)] of the Internal Revenue Code. . . .

The parties are in agreement that the plaintiff, to recover, must show the applicability of one or the other of those Sections. We agree with the District Court that he has failed to do so.

The plaintiff contends that the loss of the amount in question was due to his keeping his word, which the ethics of his profession, as well as his own conscientiousness compelled him to do, and argues that consequently the payment was made and the loss incurred in his law business, and should have been allowed as a deduction from income under one or the other of the sections referred to. His position is illustrated by his rhetorical question: Is it not part of a lawyer's business to keep his word? It might be answered that it is everybody's business to do so, but that is wide of the mark. We are obliged to inquire whether the circumstances of this loss — no matter how creditably incurred — are clearly within the coverage of either Section referred to. Nor can equitable considerations be allowed to control. The matter of deductions from income ". . . 'depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.' " Deputy v. DuPont, 308 U.S. 488, 493.

It is necessary to consider the origin of the obligation under which the taxpayer considered himself to be under when he made the payment in question, in determining whether it is a permissible deduction under either Section of the statute. It arose from the gratuitous assurance given attorneys for creditors of Wax by Mr. Friedman that the money for the composition would be forthcoming if they would approve it. In effect, it was the voluntary underwriting of the obligation of another. It was, of course, the duty of the client to furnish the money, not of his attorney. Payment of the $5000 by the attorney was made as a consequence of his undertaking and in pursuance of it and was no less voluntary than the assurance which occasioned it. From any point of view his loss was caused by his voluntary action.

As was said by this Court in the very similar case of W. F. Young, Inc. v. Commissioner, 120 F.2d 159, 166,

> Even if the credit and reputation of the taxpayer would have been improved by these payments and even though they would in any way benefit the taxpayer, voluntary payments are not deductible as ordinary and necessary business expenses or losses.

See also Robinson v. Commissioner, 8 Cir., 53 F.2d 810.

The emphasis placed by the plaintiff upon his moral obligation to keep his professional word should not obscure the fact that the transaction on his part was voluntary from the beginning.

That the circumstances of the taxpayer's payment preclude its being considered either an "ordinary and necessary expense" of his business or a loss incurred in business is clear both from the Regulations promulgated under the Internal Revenue Code and the construction [§162(a)] and [§165(a)] have received by the Courts.

The business expenses covered by the former Section are limited to those described as being "ordinary and necessary"; such as are directly connected with and proximately resulting from carrying it on; those normally originating in a liability created in the course of its operation. Deputy v. DuPont, supra. Welch v. Helvering, 290 U.S. 111.

The moral obligation which the taxpayer recognized here, to his financial

detriment, was an extra-professional liability which resulted in a loss which is certainly not clearly covered by [§162(a)] according to the accepted construction of that Section.

Nor is the taxpayer in any better case if he claims a deductible loss under [§165(a)]. His was not a business loss made in carrying on a law practice. It is obviously no part of a lawyer's business to take on a personal obligation to make payments which should come from his client, unless in pursuance of a previous understanding or agreement to do so. The voluntary nature of the action, resulting in the loss, takes it outside of this Section as well as the other. W. F. Young v. Commissioner, supra. Robinson v. Commissioner, supra.

It should be said that we also see no error in the finding of the District Court that the payment of the $5000 — if ever a proper deduction — was deductible only in 1938, when made, and not in 1941, when the taxpayer failed in an attempt to get it back. It is admittedly not a debt due the taxpayer which became "bad." The deposit was made without restriction of destination and was, for all practical purposes, gone and lost to the owner when made.

The action of the District Court in giving judgment for the defendant on the claim in the complaint for the item of $3,411.47 is affirmed. . . .

[Chief Judge Magruder, whose opinion is omitted, concurred in the result on the basis of certain additional facts that were in the record but which were not regarded as significant by either the District Court or the majority of the Court of Appeals.]

NOTE

1. *Deputy v. du Pont.* In Deputy v. du Pont, cited by the court in Friedman v. Delaney, the Supreme Court refused to permit a shareholder of the du Pont Company to deduct certain expenses arising from his sale of du Pont stock to a group of young executives. The purpose of the sale was to give these executives a financial interest in the corporation; because the corporation was prevented by legal restrictions from doing so, the taxpayer stepped in "to the end that his beneficial stock ownership in the du Pont Company might be conserved and enhanced." The deduction was denied because the expenses were attributable to the corporation's trade or business, rather than to the taxpayer's, and because, even if attributable to the taxpayer's business, the expenses were not "ordinary":

> There is no evidence that stockholders or investors, in furtherance of enhancing and conserving their estates, ordinarily or frequently lend such assistance to employee stock purchase plans of their corporations. And in absence of such evidence there is no basis for an assumption, in experience or common knowledge, that these payments are to be placed in the same category as typically ordinary expenses of such activities, e.g., rental of safe deposit boxes, cost of investment counsel or of investment services, salaries of secretaries and the like. Rather these payments seem to us to represent most extraordinary expenses for that type of activity. Therefore, the claim for deduction falls, as did the claim of an officer of a corporation who paid its debts to strengthen his own standing and credit. Welch v. Helvering [supra p. 255]. And the fact that the payments might have been necessary in the sense that consummation of the transaction . . . was beneficial to [taxpayer's] estate is of no aid. For Congress has not decreed that all necessary expenses may be deducted. Though plainly necessary they cannot be allowed unless they are also ordinary. [308 U.S. 488, 496-497.]

The government had urged as an independent objection to the deduction that the taxpayer's investment activities did not constitute a "trade or business" under §162(a), the case having arisen before the enactment of §212. The Court did not pass on this issue. Would the expenses have been deductible if §212 had been in force when they were incurred?

2. *The scrupulous lawyer and other extraordinary taxpayers.* In Pepper v. Commissioner, 36 T.C. 886 (1961), another scrupulous lawyer paid up when his client misbehaved

himself, but a deduction was allowed. The taxpayer had assisted a client to find financing for a business by approaching other clients, friends, and business acquaintances and by executing the necessary loan and security arrangements; on discovering that the client was engaged in fraudulent manipulations and that his business was bankrupt, the taxpayer and his law partner paid about $65,000 to the victims. A deduction was allowed, on the ground that the taxpayer's law practice was enhanced by his financial assistance to business clients and on the theory that the payments to the persons victimized were essential to protect his firm's goodwill and professional reputation. Friedman v. Delaney was distinguished "because there was no contention that the money involved was paid to protect or promote Friedman's business." See also Dunn & McCarthy, Inc. v. Commissioner, summarized supra page 257.

In Goedel v. Commissioner, 39 B.T.A. 1, 12 (1939), a stock dealer was denied a deduction for premiums paid on insurance on the life of the President of the United States, whose death it was feared would disrupt the stock market:

> Where, as here, the expenditure is so unusual as never to have been made, so far as the record reveals, by other persons in the same business, *when confronted with similar conditions*, . . . then we do not think the expenditure was ordinary or necessary, so as to be a deductible business expense within the intendment and meaning of the statute.

See also Levitt & Sons v. Nunan, 142 F.2d 795 (2d Cir. 1944), 160 F.2d 209 (2d Cir. 1947). In Commissioner v. Motch, 180 F.2d 859 (6th Cir. 1950), it was held that an army officer stationed in Washington could not deduct the expense of using a personal car on official business because "it is not the ordinary practice for army officers and other government officials to supply and use their own vehicles" and because use of a personal car was not "necessary" since the taxpayer could have waited for a bus or official vehicle even though "some loss of time would be occasioned." In short, the taxpayer "merely made voluntary expenditures for greater convenience and dispatch in performing his official duties and for his personal comfort." (Were the expenditures deductible as charitable contributions to the United States?)

In Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956), the court refused to allow a corporation to deduct the expense of converting a farm, owned by its president and sole shareholder, into a "unique horticultural showplace" at which he "was able to visit leisurely with his customers in pleasant surroundings and create good will for his product." The court found that "the record does not compel a conclusion that the horticultural features of the farm overwhelmed the potential customers," but stated that even if "it were to be conceded that the expenses here incurred were necessary in the sense that they were helpful to the taxpayers' business, it would still be necessary to prove such expenses were ordinary." Citing Welch v. Helvering, supra page 255, the court referred to the taxpayer's failure to prove "that the creation of a horticultural showplace by a corporation at the home of its principal officer and stockholder is such an expense as is ordinarily incurred in promoting a corporate business." (The court also pointed out that the expense enhanced the value of the stockholder's home, and expressed a fear of opening the door to questionable deductions.) Haverhill Shoe Novelty Co. v. Commissioner, 15 T.C. 517 (1950), concerned the expenses of the wedding and reception of the majority shareholder's daughter; the corporation deducted 60 per cent of the expenses on the claim that 60 per cent of the guests were persons "who would not have been invited were it not for the ordinary and necessary advertising policy of the corporation." (The court found that only a few, if any, of the guests knew "that they would not have been invited except for business reasons," and the bride's attitude was apparently not put in evidence.) Stating that it was not "ordinary and necessary" for a corporation to act as "father of the bride," the court disallowed the deduction. See also Pantages Theatre Co. v. Welch, 71 F.2d 68 (9th Cir. 1934), disallowing a deduction for payments by a corporation to defray the legal expenses incurred by its president in the defense of a rape case arising out of an "interview" with an applicant for employment; Bonney v. Commissioner, 247 F.2d 237 (2d Cir. 1957), holding that a payment by a lawyer to silence accusations that were damaging his professional reputation was not "an ordinary business expense, even assuming it to have been necessary for the protection of [taxpayer's] law practice." Com-

pare Catholic News Publishing Co. v. Commissioner, 10 T.C. 73 (1948), where a similar expense was allowed.

When denying a deduction on the ground that the expense was not "ordinary," the courts have usually relied on Welch v. Helvering and Deputy v. du Pont, supra. If the payment is not unlawful and its deduction would not contravene public policy in some fashion (a problem dealt with infra p. 279), should the deduction be denied merely because the expense is unusual, extraordinary, or unique? Did any of the cases just described reach the right result for the wrong reason?

PATTON v. COMMISSIONER

168 F.2d 28 (6th Cir. 1948)

Before Hicks, McAllister and Miller, Circuit Judges.

Hicks, Circuit Judge.

Respondent found a deficiency in the income and victory taxes for 1943 of petitioner, James F. Patton, in the sum of $16,561.12, and of petitioner, Vincent Patton, in the sum of $16,361.80. The cases were consolidated for hearing before the Tax Court and here. The Tax Court confirmed the deficiency assessments and we are asked to review its decision.

The cases arose under [§162(a)(1)].

During the calendar year 1943 petitioners were partners doing a general jobbing business under the firm name of "Patton Company, Cleveland, Ohio," and one William Kirk was an employee of the firm. The partnership claimed deductions for 1943 for compensation of $46,049.41 paid to Kirk. The Commissioner determined that $13,000.00 constituted reasonable compensation for him for that year and disallowed the deductions claimed above that amount. The Tax Court sustained the Commissioner.

Kirk kept the books and records of the partnership and rendered such other clerical and routine services as the office work required. He generally worked without assistants. Petitioners complain that the Tax Court erred in finding that Kirk kept the books on a cash basis, that his duties as a bookkeeper entailed little effort; that petitioners' production was practically supervised by Government inspectors; that Kirk was paid 10% of the net sales of the partnership; that the payments to him formed a basis for tax reduction; that he was to receive 10% of net sales so long as 10% commission, plus the $2,400.00 minimum, did not exceed 22½% of net profits.

They also complain that the Tax Court erred in failing to make findings that the petitioners and Kirk were unrelated and had no common business interests other than that created by the contract; that Kirk devoted long hours to the business; that the contract was of the "profit-sharing" type and formed a measuring rod by which Kirk's earnings were to be determined; that the court failed to make findings of the educational background of petitioners and give effect thereto. . . .

At this late date it is an elementary proposition, needing no citation of authorities to support it, that this court is without power to make findings of fact. Its function [§7482(c)(1)] is to determine whether the decision of the Tax Court is "in accordance with law." If it is, an affirmance is in order; otherwise the court may modify or reverse the decision. And in determining this question, the court is limited to ascertaining whether there was evidence to support the findings and decision of the Tax Court. We may not make an independent determination of the issues before the Tax Court nor pass upon the weight of the evidence or consider conflicting evidence nor choose between possible inferences that may arise.

The Tax Court found the following facts: Prior to July 1, 1940, petitioner, James F. Patton, operated the machine shop as an individual, during which time

his business was small. At times he had no employees and did all the work himself. At other times the work required additional help. At times his son, Vincent, assisted him, although Vincent had full time employment elsewhere. About 1937 James F. Patton employed Kirk to do his office work. Kirk had a grammar school education and a two years' commercial course in high school. From 1893 to 1919 he engaged in clerical work and following that, he operated a small trucking business until 1929. From then, until his employment by James F. Patton he had no regular employment. From 1919 to 1941 his earnings were not sufficient to require the filing of tax returns. From 1937 to 1940 Kirk's compensation was approximately as follows: For 1937, $939.00; for 1938, $1,230.00; for 1939, $1,385.00; for 1940, $1,855.00.

On July 1, 1940, James F. Patton and his son Vincent formed a partnership and shortly thereafter James F. turned over the affairs of the partnership to Vincent. Up to December 17, 1940, the partnership, called The Patton Company, did job work for general customers, but on that date The General Motors Corporation began sending work to the Company in such volume that its productive capacity was absorbed by the new customer.

On January 2, 1941, petitioners contracted in writing with Kirk whereby he was to receive a minimum salary of $2,400.00 a year until such time as 22½% of the net profits exceeded $2,400.00. In such event the contract provided that Kirk was to receive 10% of the net sales for as long as that percentage, plus the $2,400.00 basic salary, did not exceed 22½% of the net profits.

The gross sales from 1941 to 1943 were, for 1941, $179,050.00; for 1942, $365,-609.53; for 1943 [the year involved here] $460,494.06. Kirk kept the books on a cash basis in a simple way. He recorded in a cash book all receipts and disbursements and at the end of each month prepared two summary sheets, one showing total receipts and disbursements of each class and the other showing materials purchased. At the end of each year the summary sheets showing totals for each month and year were used by an accountant who translated them to an accrual basis in preparing income tax returns. Kirk kept a ledger and did the billing, which required little effort because substantially all of the Company's work was for General Motors. He prepared the payrolls, kept social security records and made quarterly social security reports. He kept petitioner Vincent Patton informed of the bank balances and transmitted to shop foremen information from General Motors as to the orders it desired to be finished first. He spoke to insurance salesmen before purchases of insurance were approved by Vincent. About five times in 1942-3 he called upon the appropriate agents for approval for wage increases for employees. Kirk was not a partner in the Patton Company nor related to either of the partners.

The case strips to one question: whether, as determined by the Commissioner, $13,000.00 was reasonable compensation to Kirk for 1943. . . .

In the proceedings before the Tax Court the presumption is that the Commissioner was right and petitioners have the burden of proving that his determination was wrong. We think that the findings of the Tax Court are supported by substantial evidence and an affirmance must result. There is no hard and fast rule by which reasonableness of compensation may be determined by the Tax Court. Every case must stand or fall upon its own peculiar facts and circumstances. Among other factors to be considered by that Court are: The nature of the services to be performed, the responsibilities they entail, the time required of the employee in the discharge of his duties, his capabilities and training, and the amount of compensation paid in proportion to net profits. An exclusive function of the Tax Court is the determination of the weight and credibility to be given to the witnesses.

We think that petitioners have failed to carry the burden, which the law imposes upon them, to make out their case by clear and convincing evidence. . . . Probably one of the most important factors in determining the reasonableness of compensation is the amount paid to similar employees by similar concerns engaged in similar industries. The petitioners introduced no evidence upon this subject. Moreover, it occurs to us that the books of the partnership kept by Kirk would have disclosed to a great extent the nature and volume of his work and his capabilities to perform it, but neither the books nor any verified entries therefrom were introduced by petitioners. There is of course a presumption that as between the parties to the contract the compensation agreed to be paid was reasonable. But, as between petitioners and the Commissioner, such a presumption is not controlling in a controversy of this nature before the Tax Court. Botany Worsted Mills v. United States, 278 U.S. 282, 292.

Affirmed.

McALLISTER, Circuit Judge (dissenting).

According to [§162(a)(1)] of the Internal Revenue Code, to which reference has been made, petitioners are entitled to a deduction in their taxes for all "the ordinary and necessary expenses paid or incurred during the taxable year in carrying on" their business, "including a reasonable allowance for salaries or other compensation for personal services actually rendered." The issue is whether the compensation which was paid to Kirk, in accordance with his contract of employment, was a reasonable allowance. As is said in the prevailing opinion, there is a presumption that, as between the parties to the contract, the compensation agreed to be paid was reasonable. But it is declared that as between petitioners herein and the Commissioner, such a presumption is not controlling in a controversy of this nature before the Tax Court, and Botany Worsted Mills v. United States, 278 U.S. 282, 292, is cited as authority to sustain this conclusion.

It does not seem to me that the *Botany Mills* case controls the controversy before us. There, the stockholders of a corporation adopted a bylaw providing for the payment of more than 50% of the annual net profits to the members of the board of directors, for their services, in addition to their regular annual salaries of $9,000 each. In 1917, the tax year there in controversy, the amount paid out of net profits to the board of directors was $1,565,739.39, or a payment to each director of $156,573.93, in addition to his salary. Under a statute, similar in phrasing to the one before us, providing for deductions of all "the ordinary and necessary expenses paid within the year in the maintenance and operation of its business," 39 Stat. 756, the court held that this amount so greatly exceeded the amounts which are usually paid to directors for their attendance at meetings of the board and the discharge of their customary duties, as to raise a strong inference that the "amount paid to the directors was *not in fact compensation for their services, but merely a distribution of a fixed percentage of the net profits* that had no relation to the services rendered." (Emphasis supplied.) The *Botany Mills* case cites three other cases . . . that seem to me to elucidate the reason for the court's decision. . . .

In all of these cases, the amounts were paid to officers who were really the beneficial owners of the corporation and who controlled its action in contracting for and paying them the unusually high salaries based upon net profits. The reasons the courts have held such salaries were not deductible as "ordinary and necessary expenses," were because they were not, in fact, compensation, but merely a distribution of profits; that such profits, divided on the basis of stock holdings, were not payments of compensation; that the claimed salaries were not salaries at all, but profits diverted to stock holding officers under the guise of salaries; and that a distribution of profits "under the guise of salaries" to officers

who held the stock of a company and controlled its affairs, is not an ordinary and necessary expense, within the meaning of the statute.

In this case, Kirk was not an owner or part owner of the company, directly or indirectly. His contract of employment, providing for a salary, based on profits, was not a distribution of profits under the guise of a salary. There is no question that the contract of employment was bona fide. As was said in United States v. Philadelphia Knitting Mills Co., [273 F.2d 657], the Government has no right to inquire into and determine whether the amount of the salary was proper, or whether it was too much or too little, but only "whether the amount paid is salary or something else."

Although much importance is seemingly attached by the Government to the fact that, before the contract of employment was entered into between Kirk and petitioners, his salary for the preceding four years was only $939, $1,230, $1,385, and $1,855, the Commissioner finally allowed a deduction on the basis of a salary to Kirk in the amount of $13,000. It can easily be perceived from the evidence that this was a purely arbitrary allowance on the part of the Commissioner. If it was based on the previous earnings of Kirk or upon what he actually did, it was obviously excessive. If it was arrived at by taking the contract for his services into consideration, it was clearly inadequate. It is impossible to escape the conclusion that the Commissioner based his allowance on the ground that the amount of compensation provided by the contract eventually turned out to be too high, merely because the profits during the years in question were so great. No such arbitrary determinations are valid, either in administrative decisions or in court adjudications. The decision that the amount provided by the contract of employment was too high was, as has been stated by the courts, no business or concern of the Government. The decisive question is whether the amount paid to Kirk was salary or a distribution of profits paid under the guise of salary. It was not a distribution of profits, for Kirk has no interest in the company.

It is admitted in this case that the amount paid to Kirk was salary, and there is nothing in the case to overcome the presumption that such compensation was reasonable. In my opinion, the partners were entitled to deduct the payment of such salary as an ordinary and necessary expense incurred during the taxable year, and the decision of the Tax Court to the contrary should be reversed.

NOTE

1. *Origin of phrase "a reasonable allowance for salaries or other compensation."* It has been shown that originally the phrase here involved — "including a reasonable allowance for salaries or other compensation for personal services actually rendered" — was intended not as a *limitation* on §162(a)'s blanket allowance of "all ordinary and necessary business expenses," but rather as an authorization to deduct an additional allowance for services where the salary *actually* paid or incurred therefor was inadequate. Griswold, New Light on "A Reasonable Allowance for Salaries," 59 Harv. L. Rev. 286 (1945). The contrary belief, that the phrase was intended to restrict rather than to enlarge what would otherwise be deductible as a business expense, however, is apparently imbedded beyond correction. See Walts, Inc. v. Commissioner, ¶47,003 P-H Memo T.C.; and note that the 1954 Code re-enacted the phrase after innumerable cases had interpreted it as a limitation on the deduction of business expenses. Its principal function has been to disallow so-called salaries that are in reality non-deductible dividends to stockholder-employees or indirect gifts by stockholders to members of their families. Such disguised dividends could of course be disallowed without the use of the "reasonable allowance" test, on the theory that they are not "expenses" at all.

The *Patton* case is unusual in this area in that the employee whose compensation is disallowed was neither a proprietor of the enterprise nor the relative of one. Wholly

extravagant salaries are unlikely to be found in such a situation except where tax rates are so high as to destroy any incentive to be economical with employees. Another occasion for wild generosity toward an employee who is neither a stockholder nor a stockholder's relative is the closely held corporation with one important "outside" executive who owns no stock. If the stockholder-executives are receiving extravagant "salaries," it may be necessary to give the outsider a slice of the melon in order to preserve intracompany harmony. See Builders Steel Co. v. Commissioner, 197 F.2d 263 (8th Cir. 1952).

One other area of possible application for the "reasonable" compensation doctrine is the publicly held corporation whose officers have control through the proxy machinery and are unduly open-handed in compensating themselves with corporate funds. But the courts have been reluctant to hold compensation unreasonable in stockholders' derivative actions, see Heller v. Boylan, 29 N.Y.S.2d 653 (1941), aff'd, 32 N.Y.S.2d 131 (1941), and this may explain why there has apparently been no attempt to disallow for tax purposes compensation paid by publicly held corporations. A possible exception is to be found in R. J. Reynolds Tobacco Co. v. United States, 149 F. Supp. 889 (Ct. Cl. 1957), cert. denied, 355 U.S. 893, see also R. J. Reynolds Tobacco Co. v. Commissioner, 269 F.2d 9 (4th Cir. 1958), disallowing certain profit-sharing payments paid, under an unusual arrangement for a widely held corporation, to employees in proportion to stockholdings.

What would be the probative effect of a disallowance of compensation in a tax case on a subsequent stockholder's suit for breach of the fiduciary obligation?

2. *Contingent compensation agreements.* Did the court find that Kirk's contract was unreasonable when made, or only that his 1943 salary (however computed and despite its contingent nature) was greater than the value of his 1943 services? Note Regs. §1.162-7(b)(2) and (3). Relying on the Regulations, the Court of Claims allowed a corporation to deduct contingent compensation that came to $177,000 as a result of war business, although when the employment contract was made the previous year it had been estimated that the officer's compensation would not exceed $50,000. Having concluded that the contract was reasonable when made, the court apparently felt that the amount actually paid under it was irrelevant. Rogers, Inc. v. United States, 93 F. Supp. 1014 (Ct. Cl. 1950). In Harolds Club v. Commissioner, ¶63,198 P-H Memo T.C., a 1941 agreement between a gambling casino and its manager (whose two sons owned the business), under which he was to receive a salary of $10,000 plus 20 per cent of the profits, produced income ranging from $350,000 to about $560,000 during the years 1952-1956. The court held that "reasonable" compensation would have been $10,000 plus 15 per cent of the profits.

3. *The recipient of excessive compensation.* If part of a salary is disallowed as unreasonable, is the recipient's tax status affected? See Regs. §1.162-8, stating that excessive compensation is taxable income to the recipient unless there is "evidence to justify other treatment." Such as? If the excessive salary is paid to a shareholder-employee and is "treated as a dividend" under Regs. §1.162-8, what is the impact of facts establishing that under applicable state law the corporation was not legally entitled to declare a dividend because it had no qualified surplus?

What if the excessive portion is returned by the recipient, either voluntarily or because of a pre-existing agreement to return any amount that might be found unreasonable on an audit of the employer's tax returns? Is §1341 applicable? See Berger v. Commissioner, 37 T.C. 1026 (1962); Leach v. Commissioner, 21 T.C. 70 (1953); Schlaudt, Returnable Compensation Arrangements in Closely Held Corporations, 8 N.Y.U. Inst. on Fed. Taxation 724 (1950).

See also Healy v. Commissioner, page 854 infra.

4. *Scope of the problem.* Whether a payment is "compensation" or a disguised dividend is one of the most commonly litigated tax questions, and the lack of standards makes for constant friction between taxpayer and government in this field. Almost every successful closely held corporation is a potential target for disallowance. The litigated cases, numerous as they are, undoubtedly represent only a small fraction of the disputes, since the factual nature of the question and the presumption of correctness enjoyed by the Commissioner both encourage settlements to avoid the cost and uncertainty of lawsuits. On the question of standards, see Regs. §1.162-7; Griswold, The Deduction of "A Reasonable Allowance for Salaries" — The Undefined Power of the Commissioner, 56 Harv. L. Rev. 997 (1943); and for details of litigated cases, see Miller, What the Tax Court Wants to

Know in a Reasonable Compensation Case, 79 J. Accountancy 366 (1945); Wolder, Facts and Figures on Reasonable Compensation, 24 Taxes 150 (1946).

5. *Must all expenses be "reasonable"?* Section 162(a)(1) in terms requires only that compensation be "reasonable." There is no such explicit requirement for other business expenses under §162(a), for non-trade and non-business expenses under §212, or for losses under §165. Must these other deductions nevertheless be "reasonable" in amount? Commissioner v. Lincoln Electric Co., 176 F.2d 815 (6th Cir. 1949); Place v. Commissioner, 17 T.C. 199, 203 (1951), aff'd per curiam, 199 F.2d 373 (6th Cir. 1952), cert. denied, 344 U.S. 927 (1953); Kilcullen, Is Reasonableness a Requirement of Non-compensation Expenses? 9 N.Y.U. Inst. on Fed. Taxation 863 (1951). If the "reasonable" restriction applies to all business deductions, was there any need for the 1962 amendment to §162(a)(2), disallowing "lavish and extravagant" travel expenses?

TANK TRUCK RENTALS, INC. v. COMMISSIONER

356 U.S. 30 (1958)

MR. JUSTICE CLARK delivered the opinion of the Court.

In 1951 petitioner Tank Truck Rentals paid several hundred fines imposed on it and its drivers for violations of state maximum weight laws. This case involves the deductibility of those payments as "ordinary and necessary" business expenses under [§162(a)]. Prior to 1950 the Commissioner had permitted such deductions, but a change of policy that year caused petitioner's expenditures to be disallowed. The Tax Court, reasoning that allowance of the deduction would frustrate sharply defined state policy expressed in the maximum weight laws, upheld the Commissioner. The Court of Appeals affirmed on the same ground, and we granted certiorari. In our view, the deductions properly were disallowed.

Petitioner, a Pennsylvania corporation, owns a fleet of tank trucks which it leases, with drivers, to motor carriers for transportation of bulk liquids. The lessees operate the trucks throughout Pennsylvania and the surrounding States of New Jersey, Ohio, Delaware, West Virginia, and Maryland, with nearly all the shipments originating or terminating in Pennsylvania. In 1951, the tax year in question, each of these States imposed maximum weight limits for motor vehicles operating on its highways. Pennsylvania restricted truckers to 45,000 pounds, however, while the other States through which petitioner operated allowed maximum weights approximating 60,000 pounds. It is uncontested that trucking operations were so hindered by this situation that neither petitioner nor other bulk liquid truckers could operate profitably and also observe the Pennsylvania law. Petitioner's equipment consisted largely of 4,500-5,000 gallon tanks, and the industry rate structure generally was predicated on fully loaded use of equipment of that capacity. Yet only one of the commonly carried liquids weighed little enough that a fully loaded truck could satisfy the Pennsylvania statute. Operation of partially loaded trucks, however, not only would have created safety hazards, but also would have been economically impossible for any carrier so long as the rest of the industry continued capacity loading. And the industry as a whole could not operate on a partial load basis without driving shippers to competing forms of transportation. The only other alternative, use of smaller tanks, also was commercially impracticable, not only because of initial replacement costs but even more so because of reduced revenue and increased operating expense, since the rates charged were based on the number of gallons transported per mile.

Confronted by this dilemma, the industry deliberately operated its trucks overweight in Pennsylvania in the hope, and at the calculated risk, of escaping the notice of the state and local police. This conduct also constituted willful violations in New Jersey, for reciprocity provisions of the New Jersey statute subjected trucks registered in Pennsylvania to Pennsylvania weight restrictions while

traveling in New Jersey. In the remainder of the States in which petitioner operated, it suffered overweight fines for several unintentional violations, such as those caused by temperature changes in transit. During the tax year 1951, petitioner paid a total of $41,060.84 in fines and costs for 718 willful and 28 innocent violations. Deduction of that amount in petitioner's 1951 tax return was disallowed by the Commissioner.

It is clear that the Congress intended the income tax laws "to tax earnings and profits less expenses and losses," Higgins v. Smith, 308 U.S. 473, 477 (1940), carrying out a broad basic policy of taxing "net, not . . . gross, income. . . ." McDonald v. Commissioner, 323 U.S. 57, 66-67 (1944). Equally well established is the rule that deductibility under [§162(a)] is limited to expenses that are both ordinary and necessary to carrying on the taxpayer's business. Deputy v. du Pont, 308 U.S. 488, 497 (1940). A finding of "necessity" cannot be made, however, if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof. Commissioner v. Heininger, 320 U.S. 467, 473 (1943); see Lilly v. Commissioner, 343 U.S. 90, 97 (1952). This rule was foreshadowed in Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941), where the Court, finding no congressional intent to the contrary, upheld the validity of an income tax regulation reflecting an administrative distinction "between legitimate business expenses and those arising from that family of contracts to which the law has given no sanction." 314 U.S., at 339. Significant reference was made in *Heininger* to the very situation now before us; the Court stated, "Where a taxpayer has violated a federal or a state statute and incurred a fine or penalty he has not been permitted a tax deduction for its payment." 320 U.S., at 473.

Here we are concerned with the policy of several States "evidenced" by penal statutes enacted to protect their highways from damage and to insure the safety of all persons using them.[1] Petitioner and its drivers have violated these laws and have been sentenced to pay the fines here claimed as income tax deductions.[2] It is clear that assessment of the fines was punitive action and not a mere toll for use of the highways: the fines occurred only in the exceptional instance when the overweight run was detected by the police. Petitioner's failure to comply with the state laws obviously was based on a balancing of the cost of compliance against the chance of detection. Such a course cannot be sanctioned, for judicial deference to state action requires, whenever possible, that a State not be thwarted in its policy. We will not presume that the Congress, in allowing deductions for income tax purposes, intended to encourage a business enterprise to violate the declared policy of a State. To allow the deduction sought here would but encourage continued violations of state law by increasing the odds in favor of noncompliance. This could only tend to destroy the effectiveness of the State's maximum weight laws.

This is not to say that the rule as to frustration of sharply defined national or state policies is to be viewed or applied in any absolute sense. "It has never been thought . . . that the mere fact that an expenditure bears a remote relation to an illegal act makes it nondeductible." Commissioner v. Heininger, supra, at 474. Although each case must turn on its own facts, Jerry Rossman Corp. v. Com-

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[1] Because state policy in this case was evidenced by specific legislation, it is unnecessary to decide whether the requisite "governmental declaration" might exist other than in an Act of the legislature. See Schwartz, Business Expenses Contrary To Public Policy, 8 Tax L. Rev. 241, 248.

[2] Unlike the rest of the States, Pennsylvania imposed the fines on the driver rather than the owner of the trucks. In each instance, however, the driver was petitioner's employee, and petitioner paid the fines as a matter of course, being bound to do so by its collective bargaining agreement with the union representing the drivers.

missioner [175 F.2d 711 (2d Cir. 1949)], the test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction. The flexibility of such a standard is necessary if we are to accommodate both the congressional intent to tax only net income, and the presumption against congressional intent to encourage violation of declared public policy.

Certainly the frustration of state policy is most complete and direct when the expenditure for which deduction is sought is itself prohibited by statute. See Boyle, Flagg & Seaman, Inc. v. Commissioner, 25 T.C. 43.* If the expenditure is not itself an illegal act, but rather the payment of a penalty imposed by the State because of such an act, as in the present case, the frustration attendant upon deduction would be only slightly less remote, and would clearly fall within the line of disallowance. Deduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the "sting" of the penalty prescribed by the state legislature.

There is no merit to petitioner's argument that the fines imposed here were not penalties at all, but merely a revenue toll. It is true that the Pennsylvania statute provides for purchase of a single trip permit by an overweighted trucker; that its provision for forcing removal of the excess weight at the discretion of the police authorities apparently was never enforced; and that the fines were devoted by statute to road repair within the municipality or township where the trucker was apprehended. Moreover, the Pennsylvania statute was amended in 1955, raising the maximum weight restriction to 60,000 pounds, making mandatory the removal of the excess, and graduating the amount of the fine by the number of pounds that the truck was overweight. These considerations, however, do not change the fact that the truckers were fined by the State as a penal measure when and if they were apprehended by the police.

Finally, petitioner contends that deduction of the fines at least for the innocent violations will not frustrate state policy. But since the maximum weight statutes make no distinction between innocent and willful violators, state policy is as much thwarted in the one instance as in the other. Petitioner's reliance on Jerry Rossman Corp. v. Commissioner, supra, is misplaced. Deductions were allowed the taxpayer in that case for amounts inadvertently collected by him as OPA overcharges and then paid over to the Government, but the allowance was based on the fact that the Administrator, in applying the Act, had differentiated between willful and innocent violators. No such differentiation exists here, either in the application or the literal language of the state maximum weight laws.

Affirmed.

COMMISSIONER v. SULLIVAN

356 U.S. 27 (1958)

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

The question is whether amounts expended to lease premises and hire employees for the conduct of alleged illegal gambling enterprises are deductible as ordinary and necessary business expenses within the meaning of [§162(a)].

The taxpayers received income from bookmaking establishments in Chicago, Ill. The Tax Court found that these enterprises were illegal under Illinois law,

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* In this case, the Tax Court held that an insurance broker could not deduct, under §162(a), payments made in violation of an Illinois criminal statute to non-licensed automobile dealers and others for soliciting insurance for it. Such payments were a common practice, the taxpayer believed them to be necessary to avoid loss of business to other brokers, and when the payments were discovered by the state authorities, the taxpayer was reprimanded but its license was not revoked and no criminal proceeding against it was commenced. — ED.

that the acts performed by the employees constituted violations of that law, and that the payment of rent for the use of the premises for the purpose of bookmaking was also illegal under that law. The Tax Court accordingly held that the amount paid for wages and for rent could not be deducted from gross income since those deductions were for expenditures made in connection with illegal acts. The Court of Appeals reversed, on the basis of its prior decision in Commissioner v. Doyle, 231 F.2d 635. The case is here on a petition for certiorari, for consideration in connection with the companion cases, Hoover Motor Express Co. v. United States and Tank Truck Rentals, Inc. v. Commissioner, decided this day.

Deductions are a matter of grace and Congress can, of course, disallow them as it chooses. At times the policy to disallow expenses in connection with certain condemned activities is clear. It was made so by the Regulations in Textile Mills Corp. v. Commissioner, 314 U.S. 326.* Any inference of disapproval of these expenses as deductions is absent here. The Regulations, indeed, point the other way, for they make the federal excise tax on wagers deductible as an ordinary and necessary business expense.† This seems to us to be recognition of a gambling enterprise as a business for federal tax purposes. The policy that allows as a deduction the tax paid to conduct the business seems sufficiently hospitable to allow the normal deductions of the rent and wages necessary to operate it. We said in Commissioner v. Heininger, 320 U.S. 467, 474, that the "fact that an expenditure bears a remote relation to an illegal act" does not make it nondeductible. And see Lilly v. Commissioner, 343 U.S. 90. If we enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it. The amounts paid as wages to employees and to the landlord as rent are "ordinary and necessary expenses" in the accepted meaning of the words. That is enough to permit the deduction, unless it is clear that the allowance is a device to avoid the consequence of violations of a law, as in Hoover Motor Express Co. v. United States, supra, and Tank Truck Rentals, Inc. v. Commissioner, supra, or otherwise contravenes the federal policy expressed in a statute or regulation as in Textile Mills Corp. v. Commissioner, supra.

Affirmed.

J. ROSSMAN CORP. v. COMMISSIONER

175 F.2d 711 (2d Cir. 1949)

Before L. Hand, Chief Judge, and Clark and Frank, Circuit Judges.

L. Hand, Chief Judge.

The petitioner appeals from an order of the Tax Court, in banc, seven judges dissenting, assessing a deficiency in its excess profits tax for the year 1943. Only one question is involved: whether the taxpayer was entitled to deduct a payment made to the United States during the year in question in circumstances to be stated. The taxpayer was a "converter" of "greige goods," which shrink or stretch in the process of dyeing to an extent not determinable in advance. During the period in question its prices were fixed upon a "cost plus" basis by regulations promulgated under the Emergency Price Control Act of 1942, 50 U.S.C.A. Appendix, §901 et seq., of which the apposite one provided that a "converter"

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* Concerning lobbying expenses, infra page 283. — Ed.

† The Regulations themselves do not refer to the federal excise tax on wagers, see 1954 Code, §4401, but a ruling cited by the Court, Rev. Rul. 54-219, 1954-1 C.B. 51, states that this tax is deductible by taxpayers engaged in the business of accepting wagers or conducting wagering pools or lotteries. — Ed.

might fix a "working allowance shrinkage" in his contracts with his customers, but that this must be limited to a maximum, which for the purpose of this appeal it is not necessary to describe. In May, 1943, the taxpayer learned that, because it had accepted and charged the shrinkage figures given it by the "finishers" to whom it had sent the goods to be dyed, it had unwittingly overcharged its customers by claiming larger shrinkages than the regulation allowed. Although the Office of Price Administration had not started any investigation of the taxpayer's charges and had not until then undertaken to investigate them, its president asked the advice of the Office as to what he should do. The official to whom he went suggested that he return the overcharges to the customers; but this was altogether impracticable. In the first place, it involved going over more than 200 accounts; and, more important, the taxpayer's customers were not entitled to the overcharges anyway, for they had passed them on to the consumers. For these reasons the official consented that the taxpayer should settle the whole matter by paying the gross overcharge to the United States in one sum and this it did on May 17, 1943. That payment is the disputed deduction. Nobody suggests that the overcharge was deliberate; but the Tax Court did find that it was "not too clear from the evidence that the overcharges in question might not have been avoided, if the petitioner had adopted other more appropriate measures."

Three questions arise: (1) whether the payment can be regarded as a "penalty" at all; (2) supposing it can be so regarded, whether no "penalties" are deductible as "ordinary and necessary expenses" of a business under [§162(a)]; and (3) if some penalties are, and some are not, deductible, whether this "penalty" is among those which may be deducted. First, it seems apparent to us that the payment of the overcharge — which is all that is here involved — can on no theory be treated as the payment of a "penalty." Taken in its broadest sense that word has a punitive, as opposed to a remedial, meaning; it covers fines and other exactions which are not restitution for a wrong, and are only justified, either as a deterrent, or in order to satisfy an atavistic craving for retaliation. A seller's duty to return the overcharge to the "terminal buyer": that is, to one "who buys . . . for use, or consumption other than in the course of trade or business," is so clearly not a "penalty" under this definition that no argument can make it plainer than its bare statement. The only possible excuse for confusion is that §205(e) [of the Emergency Price Control Act] gave to the "terminal buyer" a claim, not only to recover the overcharge, but twice its amount in addition; and we will assume that the addition was a "penalty" (though even that is not absolutely certain). However, a recovery of three times the overcharge is no less a recovery of the overcharge because it includes the penalty along with it. Hence, if the taxpayer had been able to distribute the overcharge to the "terminal buyers," and had done so, the distribution would have been deductible. It did not make such a distribution because it could not; but in its stead it paid the overcharge to the Administrator upon his agreeing not to press for more. We agree with the Commissioner that this was not a voluntary payment, or a gratuity; §205(e) [Emergency Price Control Act] imposed upon the taxpayer a duty to the Administrator in precisely the same terms as its duty to the "terminal buyer"; and, although that duty was conditional upon the "terminal buyer's" being "not entitled to bring suit," we will assume that in the case at bar that condition was fulfilled. However, the Administrator's claim, like the "terminal buyer's" claim for which it is a substitute, is also made up of the overcharge and an addition of twice its amount; and the Commissioner must maintain that the part of it, which is made up of the overcharge, is a "penalty" and loses its character as restitution even though the Administrator demands only the overcharges. There is no basis for such a conclusion. The taxpayer wished to abandon the overcharge; it recognized that the fund belonged to the

"terminal buyers"; and, since the "terminal buyer" was inaccessible, the overcharge "was subject . . . to the right of appropriation by the sovereign as bona vacantia," even though, strictly speaking, it may not have been "the subject of escheat." Indeed, if §205(e) [Emergency Price Control Act] had not intervened, conceivably as matter of strict theory, the overcharge might have passed to the several states.

Assuming, however, that we are wrong, and that the payment can be regarded as that of a penalty, the second question is whether in no circumstances could it be an "ordinary and necessary expense" of the business. The Revenue Act does not declare that penalties may not be deducted; the doctrine is a judicial gloss — and, for that matter, a gloss of the lower courts only, save as the Supreme Court recognized it by implication in Commissioner v. Heininger [320 U.S. 467]. We agree that it is a proper gloss (indeed we have ourselves enforced it several times;)[1] and its justification is that, when acts are condemned by law and their commission is made punishable by fines or forfeitures, to allow these to be deducted from the wrongdoer's gross income, reduces, and so in part defeats, the prescribed punishment. Obviously, to relieve the wrongdoer of a part of the tax due upon his income, in effect is to remit that much of the sanction imposed; as would at once be apparent, if we were to compare the case of a wrongdoer who has an income with that of one who has none. Hence, if one rigorously applied the doctrine, a taxpayer could never deduct the payment of fines and forfeitures; and we can see no relevant distinction between them and legal expenses incurred in an unsuccessful effort to prevent their collection. Indeed, to hold otherwise would be to subsidize the obduracy of those offenders who were unwilling to pay without a contest and who therefore added impenitence to their offence; and for this reason in the decisions just cited we held that such legal expenses were never deductible. The Supreme Court overruled this doctrine in Commissioner v. Heininger, supra; and the question is as to the scope of that decision. It is possible to read it as distinguishing between the legal expenses of an unsuccessful defence and the payment of fines or forfeitures. On the other hand, it is also possible to read it as meaning that, whether the claimed deduction be of legal expenses or of fines or forfeitures, its allowance depends upon the place of sanctions in the scheme of enforcement of the underlying act. We think that the second is the right reading; in short that there are "penalties" and "penalties," and that some are deductible and some are not. This we infer, not only because the result of denying deductibility only to legal expenses would, as we have said, put a premium upon resistance, but because of the following language, which was the kernel of the ratio decidendi: "If the respondent's litigation expenses are to be denied deduction, it must be because the allowance of the deduction would frustrate the sharply defined policies . . . which authorize the Postmaster General to issue fraud orders." 320 U.S. at page 474. Again: "We hold therefore that the Board of Tax Appeals was not required to regard the administrative finding of guilt . . . as a rigid criterion of the deductibility of the respondent's litigation expenses." 320 U.S. at p. 475. Perhaps the deduction of a fine or forfeiture after an "administrative finding of guilt," is more likely to "frustrate" the "sharply defined policies" of a statute which imposes it, than the deduction of the legal expenses of an unsuccessful defence — though that seems questionable — but certainly there is no more ground for taking as "a rigid criterion" the imposition of the fine than the incurrence of the expenses. Each may "frustrate the sharply defined policies" of a statute; that will depend upon how one views their deterrent

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[1] Burroughs Building Material Co. v. Com'r, 2 Cir., 47 F.2d 178; Gould Paper Co. v. Com'r, 2 Cir., 72 F.2d 698; National Outdoor Advertising Bureau v. Helvering, 2 Cir., 89 F.2d 878.

effect. We hold therefore that in every case the question must be decided ad hoc.

This conclusion leads directly to the third question: whether, even though the overcharge was a "penalty," its allowance as a deduction would "frustrate" any "sharply defined policies" of the Emergency Price Control Act of 1942. It is impossible to find an answer in general terms; indeed any answer goes to the very root of one's theory of criminal law. Happily, in the case at bar, we are not left to speculation, for we have an answer from the best possible source — the Administrator himself. The body of regulations, by which the United States sought to control prices during the last war, was extraordinarily complicated and difficult to comprehend. That was inevitable; the innumerable varieties of commercial transactions to be covered made possible nothing simpler. One may indeed argue, as the Commissioner does, that the more unsparing and relentless was the pursuit of offenders, however innocent they may have been of any wilful violation of the regulations, the more solicitous would they become to comply, and the more effective would be the enforcement of the Act. That has been a school of penology since the time of Draco; but it has not been the only school, and, as we read Commissioner v. Heininger, supra, the Supreme Court did not accept it. The Administrator did not believe that such a rigid and uncomprising policy was the best way to realize the purposes of the Act. When the amendment to §205(e) [Emergency Price Control Act] was being considered in 1944, he declared in a letter to the Senate Committee "that the protection of innocent violators from excessive damages" was "obviously desirable"; and that it had been his "policy to adjust cases involving innocent violations by payment of merely the amount of the overcharge." He thought that Congress had given him discretion not to sue for "treble damages" in some instances, and he had exercised that discretion so as "to avoid undue hardship in deserving cases." In short, he did not believe that it paid to sweep into the same pool with wilful or careless violators, violators for whom the daedalian mazes of the regulations had proved too much. Moreover Congress showed in 1944 by the amendment of §205(e) that it agreed with the Administrator. It seems to us that we should accept these expressions as evidence that in cases where the Administrator accepted the overcharge as sufficient, it did not "frustrate" any "sharply defined" policies of the Emergency Price Control Act of 1942.

Hence, we hold erroneous the order assessing the deficiency. First, we say that on no theory was the payment of the overcharge to the United States the payment of a "penalty." Second, we say that, even if it was the payment of a "penalty," that is not a "rigid criterion" of its deductibility. Third, we say that there was positive and compelling evidence that to allow such a deduction would not "frustrate" the policies of the underlying act. It is true that although the order were reversed, it would not inevitably follow that the deficiency should be expunged. The practice of the Administrator was to accept the overcharge as adequate compliance only if the seller had both acted in good faith, and had taken all "practicable precautions"; and the Tax Court found, as we said at the outset, that it was not "too clear" that in this case the taxpayer "might not have avoided" the overcharges by "more appropriate accounting." So it may be argued that the taxpayer did not carry the burden of proof of showing that the deduction would not "frustrate" the Act. It is true that this would be irrelevant to the first point; for, if the payment was only restitutionary, it could not be a penalty in any event. On the other hand, lack of proper care would be relevant to the third point: whether the allowance would "frustrate" the Act. However the Administrator's consent to accept the overcharge showed that he thought that the taxpayer had in fact used adequate care; and that was enough. We do not say that his decision was final; but it stands uncontradicted, and it was the judgment of one who was in the best possible position to make an estimate.

The deficiency determination also included adjustments not here in controversy. The order of the Tax Court is reversed; the deficiency is expunged so far as it results from disallowance of the deduction of the payment to the United States, and the cause is remanded to the Tax Court for recomputation of the taxes involved in conformity with the opinion of this court.

NOTE

1. *Fines for inadvertent violations of law.* In Hoover Motor Express Co., Inc. v. United States, 356 U.S. 38 (1958), a companion case to *Tank Truck Rentals* and *Sullivan*, the Supreme Court held that a trucking company could not deduct fines paid for "inadvertent violations of state maximum weight laws," resulting from shifting of the freight load during transit so as to overload one of the truck's axles:

> The District Court held that even if petitioner had acted innocently and had taken all reasonable precautions, allowance of the deductions would frustrate clearly defined state policy . . .
>
> Wholly apart from possible frustration of state policy, it does not appear that payment of the fines in question was "necessary" to the operation of petitioner's business. This, of course, prevents any deduction. Deputy v. du Pont, 308 U.S. 488 (1940). The violations usually resulted from a shifting of the load during transit, but there is nothing in the record to indicate that the shifting could not have been controlled merely by tying down the load or compartmentalizing the trucks. Other violations occurred because petitioner relied on the weight stated in the bill of lading when picking up goods in small communities having no weighing facilities. It would seem that this situation could have been alleviated by carrying a scale in the truck.
>
> Even assuming that petitioner acted with all due care and without willful intent, it is clear that allowance of the deduction sought by petitioner would severely and directly frustrate state policy. Tank Truck Rentals, Inc. v. Commissioner . . . As in *Tank Truck,* the statutes involved here do not differentiate between innocent and willful violators.

2. *Source of "sharply defined public policy."* In the *Lilly* case, cited in the *Tank Truck Rentals, Inc.* case, the Supreme Court held that an optician could deduct payments made to physicians who prescribed the glasses made and sold by him:

> The facts are not in dispute. The payments to the doctors were made by petitioners monthly in the regular course of their business. Under the long-established practice in the optical industry in the localities where petitioners did business, these payments, in 1943 and 1944, were normal, usual and customary in size and character. The transactions from which they arose were of common or frequent occurrence in the type of business involved. They reflected a nationwide practice. Consequently, they were "ordinary" in the generally accepted meaning of that word. See Deputy v. du Pont, 308 U.S. 488, 495; Welch v. Helvering, 290 U.S. 111, 114.
>
> The payments likewise were "necessary" in the generally accepted meaning of that word. It was through making such payments that petitioners had been able to establish their business. Discontinuance of the payments would have meant, in 1943 or 1944, either the resumption of the sale of glasses by the doctors or the doctors' reference of their patients to competing opticians who shared profits with them. Several doctors testified that they had recommended petitioners and petitioners' competitor, the American Optical Company, simultaneously. Both were sharing profits with the doctors on substantially the same basis. If either had stopped making the payments while the other continued them, there is no reason to doubt that the doctors thereafter would have omitted their recommendation of the nonpaying optician. In 1943 and 1944 the continuance of these payments was as essential to petitioners as were their other business expenses. As has been said of legal expenses

under somewhat comparable circumstances, "To say that this course of conduct and the expenses which it involved were extraordinary or unnecessary would be to ignore the ways or conduct and the forms of speech prevailing in the business world." Commissioner v. Heininger, 320 U.S. 467, 472 . . .

Assuming for the sake of argument that, under some circumstances, business expenditures which are ordinary and necessary in the generally accepted meanings of those words may not be deductible as "ordinary and necessary" expenses under [§162(a)] when they "frustrate sharply defined national or state policies proscribing particular types of conduct," nevertheless the expenditures now before us do not fall in that class. The policies frustrated must be national or state policies evidenced by some governmental declaration of them. In 1943 and 1944 there were no such declared public policies proscribing the payments which were made by petitioners to the doctors.

Customs and the actions of organized professional organizations have an appropriate place in determining in a factual sense what are ordinary and necessary expenses at a given time and place. For example, they materially affect competitive standards which determine whether certain expenditures are in fact ordinary and necessary. Evidence of them is admissible on that issue. They do not, however, in themselves constitute the "sharply defined national or state policies" the frustration of which may, as a matter of law, preclude the deductibility of an expense under [§162(a)].

We voice no approval of the business ethics or public policy involved in the payments now before us. We recognize the province of legislatures to translate progressive standards of professional conduct into law and we note that legislation has been passed in recent years in North Carolina and other states outlawing the practice here considered. We recognize also the organized activities of the medical profession in dealing with the subject. A resulting abolition of the practice will reflect itself in the tax returns of the parties without the retroactive hardship complained of here. [Lilly v. Commissioner, 343 U.S. 90, 93-98 (1952).]

Note the Supreme Court's statement that there must be "some governmental declaration" of the "sharply defined national or state" policy allegedly frustrated by the deduction. The Court of Appeals for the Fourth Circuit said of the payments in the *Lilly* case:

> A doctor owes the duty of undivided loyalty to his patients, and a contract which violates this duty is unenforcible and opposed to public policy. . . . Surely, the doctor is assuming an utterly inconsistent position when he recommends an optician without disclosing that he is being paid for the recommendation. This corrupt practice obviously involves, or tends to promote, serious evils: (1) the prescription by the doctor of glasses where not actually necessary; (2) more expensive lenses than really needed; (3) recommendation of an inferior optician; (4) artificial increase in the cost of glasses by the inclusion of the physician's commission, for which the physician affords no value to the patient. . . . We hold, since these kickbacks corrupt the fiduciary relationship between physicians and patient and result in a violation of the duty of loyalty, they are opposed to public policy. . . . [Lilly v. Commissioner, 188 F.2d 269, 271 (4th Cir. 1951).]

Why is this not a "governmental declaration" of a "sharply defined" state policy? Would a legislative resolution, condemning the practice but attaching no sanctions, warrant a denial of the deduction? Would a declaration by the *governor* meet the Supreme Court's requirement?

The Supreme Court said in the *Lilly* case that "the actions of organized professional organizations have an appropriate place in determining in a factual sense what are ordinary and necessary expenses at a given time and place." Suppose the local morticians officially frown on neon lights or the bankers condemn the luring of customers with free piggy banks — should a deduction be denied to the taxpayer who flouts custom on the ground that the expense is not "ordinary and necessary"?

After the *Lilly* case was decided, the Internal Revenue Service announced that payments made by a surgeon to other physicians for referring patients to him could be

deducted if customary in the profession, helpful in obtaining business, and not in violation of any governmentally declared national or state policy. I.T. 4096, 1952-2 C.B. 91. The American College of Surgeons has condemned the practice of fee-splitting and has urged the Service to disallow deductions for such payments.

In Kirtz v. United States, 304 F.2d 460 (Ct. Cl. 1962), the government relied on the "frustration" doctrine to disallow payments made by an insurance agent to the officers of a corporation through which business was referred to him; the court held that unless a payment was malum in se or was determined to be unlawful by the appropriate state or federal law enforcement agency, the frustration doctrine was not applicable. The *Boyle* case, supra page 274n, was distinguished on the ground that the payments in that case had been condemned by the state insurance commission.

3. *Applications of the "frustration" doctrine.* The courts have been flooded with litigation involving the "frustration" doctrine. Among many others, these cases are worthy of mention: Reuter v. Commissioner, 37 T.C. 599 (1961) (additions to federal excise tax for delinquent filing; deduction disallowed); Christodoulou v. Commissioner, ¶62,004 P-H Memo T.C. ("labor procurement expenses," evidently constituting bribes to union officials: deduction disallowed); Dixie Machine Welding & Metal Works, Inc. v. United States, 315 F.2d 445 (5th Cir. 1963) ("kickbacks" paid to officers of foreign vessels by ship repair yard to obtain business and expedite repairs, amounting to 10 per cent of repair bills; non-deductible as commercial bribes); Reffett v. Commissioner, 39 T.C. 869 (1963) (plaintiff in civil action paid a fee to witness contingent on success of lawsuit; held non-deductible by divided court); McGraw-Edison Co. v. United States, 300 F.2d 453 (Ct. Cl. 1962) (compromise damage payment for employing child labor in violation of Walsh-Healey public contracts act held non-deductible penalty, despite characterization of payments as remedial rather than penal by Secretary of Labor); United States v. Winters, 261 F.2d 675 (10th Cir. 1958) (cost of liquor used to entertain customers in a dry state); Smith v. Commissioner, 33 T.C. 861 (1960) (accord, for a taxpayer named Al Smith!).

In Atzingen-Whitehouse Dairy, Inc. v. Commissioner, 36 T.C. 173 (1961), the taxpayer violated a Pennsylvania law forbidding the sale of milk below a prescribed price by collecting the legal price but paying rebates or discounts pursuant to pre-arrangement with the customers; the court held that the taxpayer was taxable only on the amounts received less the rebates: ". . . the problem before us is not whether such discounts are deductible as 'ordinary and necessary' business expenses in arriving at net income . . . rather it is whether the discounts must be taken into account in determining the amount of gross income chargeable to petitioner in the first instance [citing the *Sullenger* case, supra p. 72]." In Stoller v. United States, 320 F.2d 340 (Ct. Cl. 1963), a warehouseman who dishonestly sold his customers' grain was taxed on the full proceeds despite his claim that the value of the grain (for which he was legally responsible to his customers) was his "cost of goods sold."

See Richey v. Commissioner, 33 T.C. 272 (1959), concerning taxpayer whose interest in "making a dollar" led him to invest $15,000 in a plan to counterfeit one hundred dollar bills; he was denied a deduction, lest public policy be frustrated, when his co-venturers absconded with his investment. Here the "frustration" doctrine was applied to a deduction claimed under §165(c)(2) and (3), although §165 does not contain the "ordinary and necessary" restriction found in §162.

In Rev. Rul. 61-115, 1961-1 C.B. 46, the Internal Revenue Service ruled that public policy would not be frustrated by allowing a corporate officer or director to deduct a payment to his corporation, pursuant to §16(b) of the Securities Exchange Act of 1934 (providing that for the purpose of preventing the unfair use of information, such persons must repay to the corporation any profit realized on a purchase and sale of its stock within a period of less than six months):

> Section 16(b) does not render the dealings of the insider unlawful or state that the amount required to be paid to the corporation constitutes a penalty. No distinction is made as to whether or not the profits were innocently derived. As distinguished from a statute which requires a wrongdoer to pay a specific amount, section 16(b) merely shifts the benefit of the insider's dealings to the corporation. It extends the

common law concept of a corporate officer's or director's fiduciary duty. The purpose of the statute is to place the insider in the same position he would have occupied if he had never engaged in the stock dealings. This purpose is not frustrated by the allowance of a tax deduction for amounts paid by reason of section 16(b); but, rather, the allowance of the deduction is consistent with the purpose of the statute in returning the insider to his original position.

The ruling indicated that the deduction would be capital or ordinary depending upon the character of the stock transaction giving rise to the gain. But what is the statutory provision affirmatively authorizing the deduction — §162, §212, §165, or something else?

If the taxpayer, in the course of a tax avoidance scheme that fails as a "sham," incurs expenses for legal and accounting advice, interest on borrowed funds, brokerage commissions, etc., are they deductible under §162, §165, or §212? Compare the majority and dissenting opinions in Fabreeka Products Co. v. Commissioner, 34 T.C. 290 (1960); Becker v. Commissioner, 277 F.2d 146 (2d Cir. 1960); DeWoskin v. Commissioner, 35 T.C. 356 (1960).

4. *Legal expenses and the "frustration" doctrine.* In the *Rossman* case, Judge L. Hand says that "we can see no relevant distinction between [fines and forfeitures] and legal expenses incurred in an unsuccessful effort to prevent their collection." Once it is determined that deduction of the fines in the *Tank Truck Rentals* and *Hoover Motor Express* cases would frustrate public policy, does it inevitably follow that a deduction of the legal expenses incurred in defending against such fines would also frustrate public policy? Would a deduction for the legal expenses "subsidize the obduracy of those offenders who were unwilling to pay without a contest and who therefore added impenitence to their offence," as suggested in *Rossman?* If so, would public policy be best served by allowing persons who plead guilty to deduct the fine, and disallowing both the fine and the legal expenses of those who demonstrate their "impenitence" by demanding a trial — or is public policy served, rather than frustrated, by allowing a deduction for the expense of defending?

For the denial of deductions where legal fees were incurred in the unsuccessful defense of criminal proceedings, see Thomas v. Commissioner, 16 T.C. 1417 (1951) (gambler convicted under local law; query the effect of the subsequently decided *Sullivan* case), and Tracy v. United States, 284 F.2d 379 (Ct. Cl. 1960) (criminal tax evasion). If the taxpayer is successful in the criminal proceeding, what must be shown to establish that the charge against him grew out of his business? Would the *Gilmore* case (supra p. 236) bar a deduction if the accused individual in the *Pantages Theater Co.* case (supra p. 266) had paid the legal fees himself? If the taxpayer is charged with criminal tax evasion, can he rely on §212(3) for a deduction in deducting the legal expenses of a successful defense? If not, does it matter whether the taxpayer is charged with fraud in connection with his business or investment income, rather than in connection with personal income or deductions (e.g., receipt of alimony, medical expenses, or dependency exemptions)?

Assuming a sufficient business connection, legal expenses incurred in civil proceedings have generally been allowed as deductions, even though fraud or similar conduct was charged and regardless of the outcome. The leading case is Commissioner v. Heininger, 320 U.S. 467 (1943) (mail fraud; taxpayer lost in proceeding to regain right to use mails); see also Longhorn Portland Cement Co. v. Commissioner, 3 T.C. 310 (1944) (state antitrust proceedings; taxpayers consented to entry of judgment against them without admitting violation); Greene Motor Co. v. Commissioner, 5 T.C. 314 (1945) (compromise of civil tax fraud case). But in Bell v. Commissioner, 320 F.2d 953 (8th Cir. 1963), a certified public accountant was denied a deduction for the expense of an unsuccessful defense of professional disciplinary proceedings growing out of a criminal tax evasion case in which he entered a plea of nolo contendere; the court held that legal fees attributable to the criminal case were non-deductible because a plea of nolo contendere is the equivalent of a plea of guilty, and then cited the *Gilmore* case (supra p. 236) in holding that the disciplinary proceedings had their origin in the taxpayer's "personal" life (viz., his commission of a crime) and hence did not grow out of his business activity. But what if the tax evasion case was based on a failure to report business income?

In Salt v. Commissioner, 18 T.C. 182 (1952), a taxpayer was allowed to deduct as a

business expense legal fees paid for advice in connection with a subpoena served by the House Committee on Un-American Activities. The taxpayer was a writer in the motion picture industry and was subpoenaed during the committee's investigation of that industry. He was not called upon to testify. The government argued that the deduction should be denied on the ground that the fees (part of a fund to which others, who refused to answer questions and were cited for contempt, also contributed) were "for the purpose of directly opposing and resisting the actual investigative function of a Congressional committee." The court found that the taxpayer did not have this intention and allowed the deduction as a business expense on the ground that the investigation was calculated to affect the future of the motion picture industry and specifically of his employment therein.

5. *Illegal businesses.* Does the principle of the *Sullivan* case extend to other businesses that are unlawful under state law but that are not subject to a federal excise tax, such as operating dice games, bootlegging, etc., or is it limited to an activity taxed by Congress and thereby recognized "as a business for federal tax purposes"? Does *Sullivan* permit a distinction between the "legal" and the "illegal" expenses of an illegal business, or are fines, bribes paid to the police, and payments to rival gangs for "protection" also deductible as "ordinary and necessary" expenses? See Hopka v. United States, 195 F. Supp. 474 (N.D. Iowa, 1961) (forfeiture of slot machines used in unlawful gambling; deduction disallowed).

Recall that in James v. United States (supra p. 110), Chief Justice Warren apparently endorsed the government's argument that if the embezzler made a repayment to his victim, it would be deductible. What is the statutory basis for such a deduction? See Wusich v. Commissioner, 35 T.C. 279 (1960), holding that a bank manager who defrauded his employer by crediting a depositor's account with fictitious deposits and by honoring overdrafts could not deduct payments made by him to the bonding company which had reimbursed the bank for the losses. Because the taxpayer's purpose was to injure and defraud the bank, the court held that the payments were not "ordinary and necessary" and that a deduction would frustrate public policy. The taxpayer was allowed, however, to deduct amounts paid to the bonding company as interest on the agreed payments. Should the payments of principal have been allowed under *James?*

Revenue Ruling 60-77, 1960-1 C.B. 386, holds that an individual engaged in an illegal trade or business must pay the self-employment (social security) tax under §1402 of the Code, relying in part on *Sullivan.* Does this embrace professional thieves and safecrackers? Will their social security benefits on retirement be appropriately geared to their incomes before retirement? Cf. Communist Party, U.S.A. v. Catherwood, 367 U.S. 389 (1961) (re status of Communist Party under New York State unemployment compensation system).

6. *Expenditures for lobbying, political campaigns, etc.* Lobbying expenses have been held non-deductible, largely because of a long-standing administrative ruling now found in Regs. §1.162-15(c). Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941); Cammarano v. United States, 358 U.S. 498 (1959) (contribution by wholesale beer dealer to finance publicity to defeat initiative measure to create state monopoly in wine and beer; held, non-deductible under the Regulations; First Amendment objection rejected on ground that denial of tax exemption puts everyone on equal economic footing and hence does not abridge free speech). For interpretations of the Regulations, see Southwestern Electric Power Co., 312 F.2d 437 (Ct. Cd. 1963) (cost of newspaper advertisements opposing a competitive federal public power system held non-deductible; legal and travel expenses for appearances before Congressional committees, urging that appropriations requested by executive departments for the system be denied, held deductible because paid to persuade Congress of illegality of appropriations rather than "to promote or defeat legislation"); Rev. Rul. 62-156, 1962-2 C.B. 47 (non-partisan activity by business firms to encourage public participation in elections, by urging public to register, sponsoring political debates, granting time off with pay on election day, and maintaining payroll deduction plan for employees wishing to make political contributions; held, not in violation of "lobbying" regulations). See Comment, Deducting Business Expenses Designed to Influence Governmental Policy as "Ordinary and Necessary": Cammarano v. United States and a Bit Beyond, 69 Yale L.J. 1017 (1960); Spiegel, Deductibility of Lobbying,

Initiative, and Referendum Expenses: A Problem for Congressional Consideration, 45 Calif. L. Rev. 1 (1957), reprinted in 35 Taxes 863 (1957).

The disallowance rules originating in Regs. §1.162-15(c) were restricted in 1962 by the enactment of §162(e), permitting taxpayers to deduct the expenses of appearances before legislative bodies in connection with legislation of direct interest to the taxpayer, dues paid to an organization to the extent attributable to such appearances, and similar expenses, provided they are related to the trade or business. Political contributions and the expense of attempting to influence the general public with respect to elections or legislative matters remain non-deductible.

The ban on deducting political contributions found in Regs. §1.162-15(c) is buttressed by §271 (supra p. 201), denying a deduction for an uncollectible loan to a political party unless the taxpayer is a bank. The campaign expenses of an unsuccessful candidate for public office were disallowed by a divided Court, in McDonald v. Commissioner, 323 U.S. 57 (1944), and a successful candidate got the same treatment in Mays v. Bowers, 201 F.2d 401 (4th Cir. 1953), where the court also refused to allow the expenses to be amortized over his official term. The court expressed the view that *allowing* a deduction would subsidize wealthy candidates, while the dissenting Justices in the *McDonald* case felt that *denying* the deduction would have this effect. In 1952, the Internal Revenue Service ruled that a Congressman might deduct the cost of printing and mailing a report on his official activities together with a "brief personal message" to his constituents:

> It is often difficult to determine the line of demarcation between deductible business expenses and non-deductible campaign expenses of a Congressman. The mere fact, however, that it might be politically expedient for a Congressman to incur an otherwise deductible expense would not ordinarily convert that expense into a non-deductible campaign expense. [I.T. 4095, 1952-2 C.B. 90.]

See also Goldman, Income Tax Incentives for Political Contributions: A Study of the 1963 Proposals, 11 U.C.L.A. Law Rev. 212 (1964); Peters, Political Campaign Financing: Tax Incentives for Small Contributors, 18 La. L. Rev. 414 (1958) (proposing a tax credit for political contributions).

In Hale, Adolph Hitler: Taxpayer, 60 Amer. Hist. Rev. 830 (1955), the author reports that the German Finance Office in 1925 allowed Adolph Hitler to deduct one half of the expenses of his political activities on the ground that while they were not in themselves deductible professional expenses, they provided material for his work as a writer and helped to increase the sale of *Mein Kampf*. This evidently established a pattern that continued through Hitler's first year as Chancellor; in 1935, however, the official in charge concluded that Hitler was tax-exempt and, when Der Fuehrer agreed with this interpretation of the applicable law, the file was closed.

7. *Payments to foreign officials*. Section 162(c), added in 1958, denies a deduction for payment to foreign officials if the payment would have been unlawful "under the laws of the United States." Does this apply a more stringent test to payments to foreign officials than would be applied to domestic transactions, by precluding the taxpayer from showing that despite the violation of law the payment did not frustrate United States public policy? Or does a payment to a public official in violation of law necessarily frustrate public policy?

Regulations §1.162-18(d) provide that a payment to a foreigner may be disallowed if its deduction would contravene United States public policy, even though §162(c) does not apply. If an American company operating in West Germany paid fines like those in the *Tank Truck* case, supra page 272, would their deduction frustrate United States public policy? Would this depend on what the Secretary of State thinks about the effect of such conduct on our foreign relations? What if the fines were paid because of a violation of the laws of East Germany or Cuba?

8. *Reference*. See generally Comment, Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code, 72 Yale L.J. 108 (1962).

2. Bad Debts

Section 166, relating to bad debts and worthless securities, is derived from §23(k) of the 1939 Code. The principal change, aside from minor revisions of phraseology, was the enactment in 1954 of §166(f) (relating to guarantors of certain obligations).

It has already been seen (supra p. 201) that bad debts are deductible, whether incurred in business or not. Some problems connected with bad debts (e.g., ascertaining the year of worthlessness) are common to business and non-business bad debts.

There are other problems, however, that are peculiar to business bad debts. Thus an individual's "non-business debts," as defined by §166(d), must be deducted when they become worthless; they do not qualify for the "bad debt reserve" method of accounting for uncollectible obligations. This method, which is widely but not universally used for business debts, starts with an estimate each year of the amount of accounts then on the taxpayer's books that will prove to be uncollectible. In making this estimate, the taxpayer may "age" his accounts receivable, i.e., classify them according to the due date and take a larger percentage of those that are seriously delinquent than of those that are only slightly in arrears. If his existing reserve (built up by deductions in previous years and reduced by debts that have actually proved uncollectible) is insufficient to provide for the estimate, the taxpayer adds an amount to the reserve to build it up to the estimate. The amount thus added to the reserve is deducted in the taxable year. See Mill Factors Corp. v. Commissioner, 14 T.C. 1366 (1950); Paramount Liquor Co. v. Commissioner, 242 F.2d 249 (8th Cir. 1957).

It will be noted that unduly pessimistic estimates in one year are corrected by adding less to the reserve in later years. Thus, if on December 31, 1963, the taxpayer had $100,000 in accounts receivable outstanding, against which a reserve of $5000 had been provided, and if $2000 of these accounts proved uncollectible during the year 1964, his bad debt reserve will have a balance of $3000 at the end of 1964. If at that time he has $90,000 of accounts, of which $4000 can be expected to prove uncollectible, the addition to the reserve in 1964 need be only $1000 to give full protection against the anticipated losses. Conversely, an unduly optimistic estimate in an earlier year will be corrected by making a larger addition to the reserve in a later year.

It has already been noted (supra p. 201) that in the case of an individual, "non-business debts" that become worthless give rise to short-term capital loss, which means that their deductibility is limited by §1211 (b). Moreover, "non-business debts" do not qualify for a partial write-off under §166(a)(2); they can be deducted only in the year of complete worthlessness.

WHIPPLE v. COMMISSIONER

373 U.S. 193 (1963)

MR. JUSTICE WHITE delivered the opinion of the Court.

Section [166(a)(1)] provides for the deduction in full of worthless debts other than nonbusiness bad debts while [§166(d)] restricts nonbusiness bad debts to the treatment accorded losses on the sale of short-term capital assets. The statute defines a nonbusiness bad debt in part as "a debt . . . other than a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business." The question before us is whether petitioner's activities in connection with several

corporations in which he holds controlling interests can themselves be characterized as a trade or business so as to permit a debt owed by one of the corporations to him to be treated within the general rule of [§166(a)(1)] as a "business" rather than a "nonbusiness" bad debt.

Prior to 1941 petitioner was a construction superintendent and an estimator for a lumber company but during that year and over the next several ones he was instrumental in forming and was a member of a series of partnerships engaged in the construction or construction supply business. In 1949 and 1950 he was an original incorporator of seven corporations, some of which were successors to the partnerships, and in 1951 he sold his interest in the corporations along with his equity in five others in the rental and construction business, the profit on the sales being reported as long-term capital gains. In 1951 and 1952 he formed eight new corporations, one of which was Mission Orange Bottling Co. of Lubbock, Inc., bought the stock of a corporation known as Mason Root Beer and acquired an interest in a related vending machine business. From 1951 to 1953 he also bought and sold land, acquired and disposed of a restaurant and participated in several oil ventures.

On April 25, 1951, petitioner secured a franchise from Mission Dry Corporation entitling him to produce, bottle, distribute and sell Mission beverages in various counties in Texas. Two days later he purchased the assets of a sole proprietorship in the bottling business and conducted that business pursuant to his franchise as a sole proprietorship. On July 1, 1951, though retaining the franchise in his own name, he sold the bottling equipment to Mission Orange Bottling Co. of Lubbock, Inc., a corporation organized by petitioner as mentioned, of which he owned approximately 80% of the shares outstanding. In 1952 he purchased land in Lubbock and erected a bottling plant thereon at a cost of $43,601 and then leased the plant to Mission Orange for a 10-year term at a prescribed rental. Depreciation was taken on the new bottling plant on petitioner's individual tax returns for 1952 and 1953.

Petitioner made sizable cash advances to Mission Orange in 1952 and 1953, and on December 1, 1953, the balance due him, including $25,502.50 still owing from his sale of the bottling assets to the corporation in July 1951, totaled $79,389.76. On December 15, 1953, petitioner advanced to Mission Orange an additional $48,000 to pay general creditors and on the same day received a transfer of the assets of the corporation with a book value of $70,414.66. The net amount owing to petitioner ultimately totaled $56,975.10, which debt became worthless in 1953 and is in issue here. During 1951, 1952 and 1953 Mission Orange made no payments of interest, rent or salary to petitioner although he did receive such income from some of his other corporations.

Petitioner deducted the $56,975.10 debt due from Mission Orange as a business bad debt in computing his 1953 taxable income. The Commissioner, claiming the debt was a nonbusiness bad debt, assessed deficiencies. The Tax Court, after determining that petitioner in 1953 was not in the business of organizing, promoting, managing or financing corporations, of bottling soft drinks or of general financing and money lending, sustained the deficiencies. A divided Court of Appeals affirmed, 301 F.2d 108, and upon a claim of conflict among the Courts of Appeals, we granted certiorari. 371 U.S. 875.

I

The concept of engaging in a trade or business as distinguished from other activities pursued for profit is not new to the tax laws. As early as 1916, Congress, by providing for the deduction of losses incurred in a trade or business separately

from those sustained in other transactions entered into for profit, §5, Revenue Act of 1916, c. 463, 39 Stat. 756, distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business. This pattern has been followed elsewhere in the Code. See, e.g., [§162(a) and §212 (ordinary and necessary expenses); §165(c)(1) and (2) (losses); §167(a)(1) and (2) (depreciation); §172(d)(4) (net operating loss deduction)]. It is not surprising, therefore, that we approach the problem of applying that term here with much writing upon the slate.

In Burnet v. Clark, 287 U.S. 410 (1932), the long-time president and principal stockholder of a corporation in the dredging business endorsed notes for the company which he was forced to pay. These amounts were deductible by him in the current year under the then existing law, but to carry over the loss to later years it was necessary for it to have resulted from the operation of a trade or business regularly carried on by the taxpayer. The Board of Tax Appeals denied the carry-over but the Court of Appeals for the District of Columbia held otherwise on the grounds that the taxpayer devoted all of his time and energies to carrying on the business of dredging and that he was compelled by circumstances to endorse the company's notes in order to supply it with operating funds. This Court in turn reversed and reinstated the judgment of the Board of Tax Appeals, since "[t]he respondent was employed as an officer of the corporation; the business which he conducted for it was not his own. . . . The unfortunate endorsements were no part of his ordinary business, but occasional transactions intended to preserve the value of his investment in capital shares. . . . A corporation and its stockholders are generally to be treated as separate entities." A similar case, Dalton v. Bowers, 287 U.S. 404, decided the same day, applied the same principles.

A few years later, the same problem arose in another context. The taxpayer with large and diversified investment holdings, including a substantial but not controlling interest in the du Pont Company, obtained a block of stock of that corporation for distribution to its officers in order to increase their management efficiency. The taxpayer, as a result, became obligated to refund the annual dividends and taxes thereon and these amounts he sought to deduct as ordinary and necessary expenses paid or incurred in the carrying on of a trade or business pursuant to §23(a) of the Revenue Act of 1928 [§162(a), 1954 Code]. The Court, Deputy v. du Pont, 308 U.S. 488 (1940), assuming arguendo that the taxpayer's activities in investing and managing his estate were a trade or business, nevertheless denied the deduction because the transactions "had their origin in an effort by that company to increase the efficiency of its management" and "arose out of transactions which were intended to preserve his investment in the corporation. . . . The well established decisions of this Court do not permit any such blending of the corporation's business with the business of its stockholders." 308 U.S., at 494. Reliance was placed upon Burnet v. Clark and Dalton v. Bowers, supra.

The question assumed in *du Pont* was squarely up for decision in Higgins v. Commissioner, 312 U.S. 212 (1941). Here the taxpayer devoted his time and energies to managing a sizable portfolio of securities and sought to deduct his expenses incident thereto as incurred in a trade or business under [§162(a)]. The Board of Tax Appeals, the Court of Appeals for the Second Circuit and this Court held that the evidence was insufficient to establish taxpayer's activities as those of carrying on a trade or business. "The petitioner merely kept records and collected interest and dividends from his securities, through managerial attention for his investments. No matter how large the estate or how continuous or extended the work required may be, such facts are not sufficient as a matter of law to permit the courts to reverse the decision of the Board." 312 U.S., at 218.

Such was the state of the cases in this Court when Congress, in 1942, amended the Internal Revenue Code in respects crucial to this case. In response to the *Higgins* case and to give relief to Higgins-type taxpayers, see H.R. Rep. No. 2333, 77th Cong., 2d Sess. 46, [the law] was amended not by disturbing the Court's definition of "trade or business" but by following the pattern that had been established since 1916 of "[enlarging] the category of incomes with reference to which expenses were deductible," McDonald v. Commissioner, 323 U.S. 57, 62; United States v. Gilmore, 372 U.S. 39, 45, to include expenses incurred in the production of income [§212(1) and (2)].

At the same time, to remedy what it deemed the abuses of permitting any worthless debt to be fully deducted, as was the case prior to this time, see H.R. Rep. No. 2333, 77th Cong., 2d Sess. 45, Congress restricted the full deduction under [§166(a)] to bad debts incurred in the taxpayer's trade or business[1] and provided that "nonbusiness" bad debts were to be deducted as short-term capital losses. Congress deliberately used the words "trade or business," terminology familiar to the tax laws, and the respective committees made it clear that the test of whether a debt is incurred in a trade or business "is substantially the same as that which is made for the purpose of ascertaining whether a loss from the type of transaction covered by [§165(c)] is 'incurred in trade or business' under paragraph (1) of that section." H.R. Rep. No. 2333, 77th Cong., 2d Sess. 76-77; S. Rep. No. 1631, 77th Cong., 2d Sess. 90. Section [165(c)(1)], of course, was a successor to the old §5 of the Revenue Act of 1916 under which it had long been the rule to distinguish between activities in a trade or business and those undertaken for profit. The upshot was that Congress [enacted §212(1) and (2)] to reach income producing activities not amounting to a trade or business and conversely narrowed [§166(a)] to exclude bad debts arising from these same sources.

The 1942 amendment of [§166], therefore, as the Court has already noted, Putnam v. Commissioner, 352 U.S. 82, 90-92, was intended to accomplish far more than to deny full deductibility to the worthless debts of family and friends. It was designed to make full deductibility of a bad debt turn upon its proximate connection with activities which the tax laws recognized as a trade or business, a concept which falls far short of reaching every income or profit making activity.

II

Petitioner, therefore, must demonstrate that he is engaged in a trade or business, and lying at the heart of his claim is the issue upon which the lower courts have divided and which brought the case here: That where a taxpayer furnishes regular services to one or many corporations, an independent trade or business of the taxpayer has been shown. But against the background of the 1942 amendments and the decisions of this Court in the *Dalton, Burnet, du Pont* and *Higgins* cases, petitioner's claim must be rejected.

Devoting one's time and energies to the affairs of a corporation is not of itself,

[1] "The character of the debt for this purpose is not controlled by the circumstances attending its creation or its subsequent acquisition by the taxpayer or by the use to which the borrowed funds are put by the debtor, but it is to be determined rather by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt is not a nonbusiness debt for the purposes of this amendment." H.R. Rep. No. 2333, 77th Cong., 2d Sess. 77; S. Rep. No. 1631, 77th Cong., 2d Sess. 90. . . .

[See, however, the subsequently enacted proviso of §166(d)(2)(A), permitting a debt to qualify as a business debt if it was created or acquired in connection with a trade or business of the taxpayer. —ED.]

and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation. Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.

If full-time service to one corporation does not alone amount to a trade or business, which it does not, it is difficult to understand how the same service to many corporations would suffice. To be sure, the presence of more than one corporation might lend support to a finding that the taxpayer was engaged in a regular course of promoting corporations for a fee or commission, see Ballantine, Corporations (rev. ed. 1946), 102, or for a profit on their sale, see Giblin v. Commissioner, 227 F.2d 692 (C.A. 5th Cir.), but in such cases there is compensation other than the normal investor's return, income received directly for his own services rather than indirectly through the corporate enterprise, and the principles of *Burnet, Dalton, du Pont* and *Higgins* are therefore not offended. On the other hand, since the Tax Court found, and the petitioner does not dispute, that there was no intention here of developing the corporations as going businesses for sale to customers in the ordinary course, the case before us inexorably rests upon the claim that one who actively engages in serving his own corporations for the purpose of creating future income through those enterprises is in a trade or business. That argument is untenable in light of *Burnet, Dalton, du Pont* and *Higgins,* and we reject it.[2] Absent substantial additional evidence,[3] furnishing management and other services to corporations for a reward no different than that flowing to an investor in those corporations is not a trade or business under [§166(d)]. We are, therefore, fully in agreement with this aspect of the decision below.

III

With respect to the other claims by petitioner, we are unwilling to disturb the determinations of the Tax Court, affirmed by the Court of Appeals, that petitioner was not engaged in the business of money lending, of financing corporations, of bottling soft drinks or of any combination of these since we cannot say they are clearly erroneous. See Commissioner v. Duberstein, 363 U.S. 278, 289-291. Nor need we consider or deal with those cases which hold that working as a corporate executive for a salary may be a trade or business. E.g., Trent v. Commissioner, 291 F.2d 669 (C.A. 2d Cir.). Petitioner made no such claim in either the Tax Court or the Court of Appeals and, in any event, the contention would be ground-

2 To the extent that they hold or contain statements to the contrary, we disapprove of such cases as Maytag v. United States, 289 F.2d 647 (Ct. Cl. 1961); Mays v. Commissioner, 272 F.2d 788 (C.A. 6th Cir.); Commissioner v. Stokes' Estate, 200 F.2d 637 (C.A. 3d Cir.); Foss v. Commissioner, 75 F.2d 326 (C.A. 1st Cir.); Washburn v. Commissioner, 51 F.2d 949 (C.A. 8th Cir.); Sage v. Commissioner, 15 T.C. 299; Campbell v. Commissioner, 11 T.C. 510; and Cluett v. Commissioner, 8 T.C. 1178.

3 Compare Maloney v. Spencer, 172 F.2d 638 (C.A. 9th Cir.), and Dorminey v. Commissioner 26 T.C. 940.

less on this record since it was not shown that he has collected a salary from Mission Orange or that he was owed one. Moreover, there is no proof (which might be difficult to furnish where the taxpayer is the sole or dominant stockholder) that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee. Compare Trent v. Commissioner, supra.

We are more concerned, however, with the evidence as to petitioner's position as the owner and lessor of the real estate and bottling plant in which Mission Orange did business. The United States does not dispute the fact that in this regard petitioner was engaged in a trade or business[4] but argues that the loss from the worthless debt was not proximately related to petitioner's real estate business. While the Tax Court and the Court of Appeals dealt separately with assertions relating to other phases of petitioner's case, we do not find that either court disposed of the possibility that the loan to Mission Orange, a tenant of petitioner, was incurred in petitioner's business of being a landlord. We take no position whatsoever on the merits of this matter but remand the case for further proceedings in the Tax Court.

Vacated and remanded.

MR. JUSTICE DOUGLAS dissents.

NOTE

1. *Alternative modes of financing a closely held business.* If Mr. Whipple had advanced the necessary funds to his corporation by purchasing additional stock, making a contribution to its capital, or lending funds on the strength of the corporation's bonds or debentures, the loss incurred when such securities became worthless would be governed by §166(e) and §165(g): it would be a capital loss as of the last day of the taxable year, long-term or short-term depending upon the taxpayer's holding period for the securities in question. If the corporation had obtained the necessary funds by borrowing from a bank on the strength of a guarantee by Mr. Whipple, his loss would have been governed by principles discussed in paragraph 4 infra. Finally, if the business had been conducted as a sole proprietorship or partnership rather than in corporate form, his loss would have been an ordinary loss under §162(a) (ordinary and necessary business expenses) or §165(c)(1) (loss incurred in trade or business). For the special treatment of losses incurred by a so-called "Subchapter S corporation," see infra pages 740 et seq.

2. *Purpose of §166(d).* When §166(d) was enacted in 1942, the only explicit statement of its purpose referred to claims for losses on "loans which [taxpayers] do not expect to be repaid." It was presumably thought that difficulties of proof made it impossible to rebut claims for "losses" that were in effect gifts to relatives or friends, and that the next best thing was a mechanical rule subjecting all non-business debts to the limited deductibility of capital losses. It was held in Putnam v. Commissioner, 352 U.S. 82 (1956), however, that the 1942 amendment had another purpose: to put "nonbusiness investments in the form of loans on a footing with other nonbusiness investments." The capital loss provisions had for many years provided that a taxpayer who acquired bonds, debentures, or other securities for investment would realize a capital loss on worthlessness; and the *Putnam* case concluded that §166(d) was designed in part to treat worthless loans that are not evidenced by a "security" consistently with those that are. As indicated supra, however, this aim is not fully accomplished, since non-business bad debts always give rise to short-term capital losses under §166(d), while the capital loss produced by a bad debt that is evidenced by a security may be either short term or long term. Note also that §166(d) does not apply to corporate taxpayers.

3. *Impact of Whipple case on prior cases under §166(d).* Maytag v. United States and the other cases cited and disowned by the Court in footnote 2 of the opinion suggest

[4] Although petitioner received no rental payments from Mission Orange, there was rent owing to him under the 10-year-lease agreement.

that the corporate veil may be disregarded if the taxpayer is "more than" an "investor" in a group of corporations in a single industrial area:

> [The findings] show, we think, that the plaintiff's business was a myriad of activities, all directly connected with aviation, which could be carried on as relatively small business enterprises without involving outside capital in large amounts. The plaintiff, for reasons satisfactory to him, carried on these enterprises in corporate form. He was not involved in these corporations merely as an investor. He worked in them, made the important decisions in them, put up the money to enable them to operate. . . . Our conclusion is that these activities were his business, and that the bad debt which he seeks to deduct was a business bad debt. [Maytag v. United States, 289 F.2d 647, 649.]

Note that the Supreme Court in *Whipple* reserved judgment on the *Trent* case, in which the Court of Appeals for the Second Circuit held that loans made by a minority shareholder to the corporation by which he was employed in order to hold his job were business, rather than non-business, debts, not subject to the restriction of §166(d). If the *Trent* case is going to be of little aid to a taxpayer who is the dominant shareholder of his corporate employer, as the Supreme Court intimates in the *Whipple* case, what chance did the taxpayer have of winning on the remand of the *Whipple* case?

4. *Loss resulting from guarantee of debt.* A series of cases in the Courts of Appeals during the years 1951-1956 indicated that a taxpayer in Mr. Whipple's position could avoid the restriction of §166(d) by guaranteeing the corporation's bank loans, instead of lending the funds himself. These cases held that a taxpayer who had to make good on a guarantee, when the primary obligor defaulted, was entitled to an ordinary loss under §165(c)(2), rather than being restricted by §166(d) to a short-term capital loss. The cases are cited in Putnam v. Commissioner, supra, which overruled them, holding that the guarantor's loss must be treated as a bad debt, subject to §166(d) if it does not arise in his trade or business. The Court pointed out that the guarantor, by paying the debtor's obligation to the creditor, is subrogated to that obligation and concluded from this principle of private law that "the loss sustained by the guarantor unable to recover from the debtor is by its very nature a loss from the worthlessness of a debt." (Query: does theft or embezzlement, by creating an obligation in the wrongdoer to repay the victim, give rise to a bad debt loss under §166 rather than to a casualty loss under §165?)

The effect of the *Putnam* case is somewhat diluted by §166(f), a curious provision that entered the Code in 1954. Under it, a taxpayer is relieved from the restriction of §166(d) if he guarantees the debt of an individual who uses the proceeds in his trade or business. The provision is not applicable to guarantees of corporate obligations, nor to individual obligations if the proceeds are not used in the borrower's trade or business. When applicable, §166(f) restores the disparity between guarantees and direct loans that was eliminated for pre-1954 years by the *Putnam* case. Does it also permit the taxpayer to deduct a "loss" on a guarantee that was intended as a gift to the borrower from the outset?

In the first case decided under §166(f), the court held that funds borrowed to finance the acquisition of a business interest were "used in the trade or business of the borrower" within the meaning of §166(f). Axelrod v. Commissioner, 320 F.2d 327 (6th Cir. 1963).

In his dissenting opinion in the *Putnam* case, Mr. Justice Harlan attempted to explain the rationale of §166(f). See Surrey, The Congress and the Tax Lobbyist — How Special Tax Provisions Get Enacted, 70 Harv. L. Rev. 1145, 1149n (1957), stating that §166(f) "reportedly was designed to meet the problem of a Texas father who had made advances to his son's business" and that the dissent in the *Putnam* case "labors long to gather an intelligible legislative history . . . but fails to realize that the provision has all the earmarks of an ad hoc resolution of a particular situation."

5. *Debts arising in the taxpayer's former business.* Note the definition of "non-business debt" in §166(d)(2). Before 1954, the statute included clause (B) of this definition, but clause (A) is new in the 1954 Code. It overrules the position taken in the pre-1954 Regulations, that even though a claim arose in connection with the taxpayer's trade or business, it is a non-business debt if he is no longer engaged in a trade or business when it becomes worthless.

6. *References.* Note, Shareholder-Creditor Bad Debts Under Section 166 of the Internal Revenue Code, 75 Harv. L. Rev. 589 (1962); Allen and Orechkoff, Toward a More Systematic Drafting and Interpreting of the Internal Revenue Code: Expenses, Losses and Bad Debts, 25 U. of Chi. L. Rev. 1, 48 et seq. (1957); Brown, Putnam v. Commissioner — The Reimbursable Outlay Under the Tax Law, 6 Buffalo L. Rev. 283 (1957); Note, Section 166(f) of the Internal Revenue Code: Bad Debts and Confusion Guaranteed, 65 Yale L.J. 247 (1955).

3. *Depreciation and Amortization*

Section 167 of the 1954 Code, relating to depreciation, is derived from §23(1) of the 1939 Code, but with substantial modifications.

BUREAU OF INTERNAL REVENUE, BULLETIN F
1-5, 1942

DEPRECIATION — OBSOLESCENCE — DEFINITIONS

The Federal income tax in general is based upon net income of a specified period designated as the taxable year. The production of net income usually involves the use of capital assets which wear out, become exhausted, or are consumed in such use. The wearing out, exhaustion, or consumption usually is gradual, extending over a period of years. It is ordinarily called depreciation, and the period over which it extends is the normal useful life of the asset.

It is elemental that in determining the net income derived from the operation of a trade or business, all operating costs and expenses allowable as deductions must be determined and deducted from the gross income. The consumption of trade or business capital represented by depreciation is an operating cost the deduction of which in computing net income is specifically provided for in the Internal Revenue Code [§167(a)] and several prior Revenue Acts, as follows:

Depreciation. A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

The factors of wear and tear and decay cause physical exhaustion, or deterioration, ultimately resulting in retirement of the property, while those retirements due to obsolescence are caused by forces ordinarily unrelated to physical condition.

Obsolescence may be defined as the process of becoming obsolete due to progress of the arts and sciences, changed economic conditions, legislation, or otherwise, which ultimately results in the retirement or other disposition of property. As said by the Supreme Court in United States Cartridge Co. v. United States, 284 U.S. 511, 516 (1932):

Obsolescence may arise from changes in the art, shifting of business centers, loss of trade, inadequacy, supercession, prohibitory laws and other things which, apart from physical deterioration, operate to cause plant elements or the plant as a whole to suffer diminution in value.

With respect to any property for which past experience indicates a gradual lessening of useful value due to inadequacy or obsolescence and when the effects of such factors can be expected to continue without substantial variation, the annual diminution in useful value is considered ordinary or normal obsolescence to be included in depreciation. Much of the discussion hereinafter having specific reference to depreciation only is in fact equally applicable to normal obsolescence.

Some property, however, may become obsolete or inadequate due to revolu-

tionary or radical changes unforeseen and unpredictable by their nature when the property was acquired. To distinguish from the allowance for what is considered normal obsolescence, this type is usually termed extraordinary or special obsolescence, allowances for which will be dealt with more specifically hereinafter. . . .

Allowance for Depreciation and Obsolescence

The proper allowance for exhaustion, wear and tear, including obsolescence, of property used in trade or business is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate) whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the property in the business, equal the cost or other basis of the property. In no instance may the total amount allowed be in excess of the amount represented by the difference between the cost or other allowable basis and the salvage value which reasonably may be expected to remain at the end of the useful life of the property in the trade or business.

The allowance in any given year must be determined in accordance with the conditions existing at the end of the year, and a taxpayer is not permitted under the law to take advantage in later years of his prior failure to take any depreciation deduction or of his action in taking deductions plainly inadequate under the known facts in prior years.

Probable Useful Life — Rate of Depreciation and Obsolescence

In general. The amount of the annual deduction allowable for depreciation is ordinarily dependent upon the expected useful life of the asset. The factors which determine the useful life of property in a trade or business have already been discussed briefly in the Introduction. These factors are wear and tear and decay or decline from natural causes; and also various forms of obsolescence attributable to the normal progress of the art, economic changes, inventions, and inadequacy to the growing needs of the trade or business. Two principal forms or types of obsolescence are generally recognized, that is, normal obsolescence and extraordinary or special obsolescence.

Normal obsolescence is caused by factors which can be anticipated with substantially the same degree of accuracy as other ordinary depreciation factors, such as wear and tear, corrosion or decay. Accordingly, it is included in estimating the normal useful life of depreciable property, the effect of which is to include the allowance for normal obsolescence in the depreciation deduction.

Extraordinary or special obsolescence rarely can be predicted prior to its occurrence. However, this does not necessarily imply that the asset already must have been completely discarded or become useless, but merely that a point has been reached where it can be definitely predicted that its use for its present purpose will be discontinued at a certain future date. Deductions for obsolescence of this type may be taken over the period beginning with the time such obsolescence is apparent and ending with the time the property will become obsolete. In every case the burden of proof is entirely upon the taxpayer to establish a claim for obsolescence by facts and evidence that are definite and indisputable. No amount may be charged off in any year merely because, in the opinion of the taxpayer, property may become obsolete a number of years later. The allowance will be confined to such items or such portion of the property on which obsolescence is definitely shown to be sustained, and cannot be held applicable to an entire property unless all portions thereof are affected by the conditions to which

the obsolescence is found to be due. Nor can obsolescence be allowed retrospectively in the light of subsequent events or happenings not anticipated during the period for which the obsolescence is claimed. In no case may the deduction for obsolescence be extended to include shrinkage in value due to other causes, as, for instance, a general drop in the price of commodities.

Past experience, which is a matter of fact and not of opinion, coupled with informed opinion as to the present condition of the property, and current developments within the industry and the particular trade or business, furnish a reliable guide for the determination of the useful life of the property. Such a determination should reflect all the peculiar circumstances of the use or operation of the property, such as the purpose for which it is utilized, the conditions under which it is used or operated, the policy as to repairs, renewals, and improvements, and the climatic and other local conditions.

Unusual conditions; abnormal depreciation. It is recognized that the useful life of some depreciable property, or items thereof, may be affected by a radical increase or decrease in plant activity, or diversion in use, extending over a period of time so that depreciation in excess of, or less than, the amounts allowable under normal operating conditions or use may be sustained. Such increase or decrease in depreciation is dependent upon the decrease or increase, respectively, in the normal useful life resulting from the exceptional operating conditions or use. However, where factors of obsolescence and inadequacy and decay control the useful life of property, no increase or decrease from normal depreciation will be allowed. Any modification of normal depreciation, therefore, must be confined to those items the useful lives of which are controlled by the factor of use or wear and tear. Moreover, since accelerated use of property is almost invariably accompanied by an increase in maintenance and repair charges, accelerated depreciation is allowable only to the extent that such maintenance and repair fail to arrest acceleration or depreciation.*

Methods of Apportionment

The capital sum to be replaced by allowances for depreciation over the useful life of the property may either be deducted in equal annual installments or in accordance with any other recognized trade practice, such as apportionment to units of production. While no specific method is prescribed, whatever plan or method of apportionment is adopted must be reasonable and cannot be changed in a later year without the consent of the Commissioner. The methods in general use by taxpayers are the "straight-line" and the "unit of production," the latter being used for the most part by taxpayers owning natural resource property. These, with other methods used to a lesser extent, are described below.

Straight-Line Method

Under this method, the cost or other basis of the property, less its estimated salvage value, is deducted in equal annual installments over the period of its estimated useful life. Ordinarily, the depreciation deduction is computed by applying a depreciation rate expressed as a percentage to the cost or other basis to be recovered, but it also may be computed by dividing that cost or other basis by the estimated useful life. The estimated useful life is subject to modification in the light of conditions known to exist at the end of each taxable period. Ordinarily, depreciation computed by this method represents the actual diminution in

* For the problems of proof in a claim for accelerated depreciation based on abnormal use of equipment (longer hours in wartime), see Copifyer Lithograph Corp. v. Commissioner, 12 T.C. 728 (1949). — Ed.

service value from year to year as closely as the depreciation computed by any other method. The practical simplicity in accounting records required and the ease and facility by which revisions or changing life estimates may be applied tend to make this method the most acceptable one for general use.

Unit of Production Method

This method is peculiarly applicable in determining depreciation for property used in the exploitation of natural resources, such as mineral deposits or timber, the available reserves of which limit the useful life of the depreciable property. Under such circumstances, the rate of exhaustion of the natural resource measures the useful life of the physical property. By dividing the cost or other basis less estimated salvage value by the estimated available reserves of raw material, a unit cost is obtained which, when multiplied by the units produced during a given year, gives the depreciation sustained for that year. Depreciation, at least to the extent of that based upon decay and normal obsolescence, is allowable and should be deducted during the period when property is idle or is producing at a rate below normal.

In the case of depreciable property the useful life of which is not limited by sources of supply, however, uncertain and unpredictable factors arise to such an extent as to make application of the method very difficult, if not impossible. Use of the method must be confined to those items in the property account whose lives are determined by the factors of wear and tear or where the extent of use or the rate of production measures the rate of exhaustion of the property. When such a separation can be made, it is then necessary to forecast for those items the useful lives of which are controlled by extent of use the total number of units to be produced during their useful lives, in order to obtain a cost factor to be applied against units produced each year in arriving at the depreciation allowance. For most property it is not possible to obtain this information with any reasonable degree of accuracy and, therefore, the method is not considered an acceptable one for general application to the machinery account of industrial concerns, or to the property of those companies exploiting a natural resource with reserves sufficient to extend operations beyond the physical life of the original plant.

Declining Balance Method

Under this method the amount of depreciation is subtracted annually from the cost or other basis of the property and the rate applied only to the resulting balances. Depreciation on any single item is largest in amount the first year and declines each year thereafter. . . .

Retirement Accounting

In this form or method of accounting for a depreciable property, the cost of property retired each year is credited to the capital asset account and, less net salvage (actual or estimated), charged to expense in lieu of annual provisions for depreciation. . . .

NOTE

1. *Methods of computing depreciation.* The straight line method of computing depreciation is by far the most commonly employed. The retirement method is largely restricted to railroads, where it has long been sanctioned by regulatory bodies for fixing rates. See, for an example of its use, Commissioner v. Union Pacific R.R., 188 F.2d 950 (2d Cir. 1951). The declining balance method, or at least a peculiar variation of it, was authorized by the Internal Revenue Service in 1946 as a method of encouraging post-war

building construction, since it would permit larger than normal (i.e., straight line) deductions during the early years after construction when taxes were higher (it was thought) than they would be later. Mayer, Declining Balance Depreciation, 25 Taxes 162 (1947).

The 1954 Code carries over without change the general provision of earlier law that the depreciation deduction shall be a "reasonable allowance" for exhaustion and wear and tear. It also provides that for certain property acquired or constructed after December 31, 1953, the term "reasonable allowance" shall include (but is not limited to) an allowance computed under certain specified methods; these are the straight line, the declining balance, and the "sum of the years-digits" methods, and any other consistent method that will not during the first two thirds of the property's life produce aggregate allowances greater than the declining balance method. The point of §167(b) is to give statutory sanction to the use of several methods (in addition to any methods that are acceptable by virtue of the general provision for a "reasonable allowance") that will afford larger depreciation allowances during the earlier years of the property's life. To encourage new investment, this privilege is limited to post-1953 property.

The declining balance method that is specifically allowed by §167(b)(2) will permit approximately 40 per cent of an asset's cost to be depreciated in the first quarter of its service life, and two thirds in the first half of its life. Section 167(b)(4), sanctioning any other consistent method that for the first two thirds of the asset's life will not yield aggregate allowances greater than the declining balance method, permits the taxpayer to avoid certain technical drawbacks in the declining balance method that are explained in the Senate Report on the 1954 Code pp. 26-27.

The "sum of the years-digits" method can be best explained by illustration: assuming property with a useful life of 6 years, the taxpayer would compute the sum of $1 + 2 + 3 + 4 + 5 + 6$, or 21, and would take a deduction of $\frac{6}{21}$ of the property's depreciable basis for the first year, $\frac{5}{21}$ for the second year, etc. This method yields deductions that are similar to the declining balance method.

The allowances for depreciation under the three statutory methods are compared in the following table, which is based upon equipment having an estimated useful life of 10 years, a cost of $2100, and an estimated salvage value at the end of its useful life of $100.

Year	*Straight Line (10 per cent)*	*Declining Balance (20 per cent)*	*Sum of the Years-Digits*
1	$200	$420.00	$363.64
2	200	336.00	327.27
3	200	268.80	290.90
4	200	215.04	254.54
5	200	172.03	218.18
6	200	137.63	181.82
7	200	110.10	145.45
8	200	88.08	109.09
9	200	70.46	72.74
10	200	56.37	36.37
Total	$2,000	$1,874.51	$2,000.00
Salvage value or unrecovered cost	$100	$225.49 *	$100.00

* To avoid having so large an unrecovered cost (which would be applied against the proceeds if the asset is sold in the final year or deducted if it is abandoned), the taxpayer may avail himself of the option granted by §167(e) to shift to the straight line method toward the end of the asset's useful life and depreciate it during the remaining years down to the estimated salvage value.

2. *Special incentives: additional first-year depreciation for "small business."* By virtue of §179, enacted in 1958, the taxpayer is entitled to an additional depreciation allowance of 20 per cent of the cost of tangible personal property having a useful life of 6 years or more; the allowance may be taken only in the first year for which depreciation is allowable

for the property, and the maximum cost qualifying for the allowance is $10,000 ($20,000 on a joint return of husband and wife) per year. The provision contains a number of restrictions, designed primarily to forestall transfers of property within a family or other related group as a means of getting more than one "first-year" allowance for the same property and to prevent an affiliated group of corporations from claiming the allowance on more than $10,000 of property in a single year. Although §179's catch-title refers to "small business," the allowance is not tied in any way to the taxpayer's gross receipts, net worth, or total assets.

Canada has employed the depreciation deduction for precisely the opposite purpose: to discourage certain classes of capital investment. Unless the taxpayer obtained a certificate from the Ministry of Trade and Commerce, no depreciation on assets acquired after April, 1951, could be taken for a period of four years. See McGurran, Deferred Depreciation, 4 Nat. Tax J. 299 (1951).

3. *Special incentives to investment: the 1962 investment credit.* A further incentive to investment was the enactment in 1962 of §38 and §§46-48, granting an "investment credit" for certain depreciable property acquired or constructed by the taxpayer after December 31, 1961. To qualify for the credit (which is applied against the tax liability itself, rather than used as a deduction in computing taxable income), the property must have a useful life of 4 years or more, and it must be either (a) tangible personal property (e.g., machinery, equipment, and vehicles), or (b) other tangible property used as an integral part of manufacturing, extraction, transportation, or certain other business activities (e.g., blast furnaces, railroad tracks, and oil pipelines). In no event, however, do buildings and their "structural components" qualify. There are certain other exclusions, including most property used predominantly outside the United States and property used by federal, state, and local governments; the former exclusion reflects the legislative purpose of encouraging domestic rather than foreign investment, and the latter no doubt rests on the premise that no investment incentive is needed for assets that are leased or otherwise made available to governmental agencies. In furtherance of the purpose of the legislation, the emphasis is on newly constructed property; used property is not entirely disqualified, but it is subject to special restrictions and no more than $50,000 of such property may qualify for the credit in any taxable year.

The credit itself is 7 per cent of the taxpayer's "qualified investment," a term that is defined by §46(c) and will ordinarily mean 100 per cent of the cost of qualified property with a useful life of 8 years or more, two thirds of the cost of property with a useful life of 6 to 8 years, and one third of the cost of property with a useful life of 4 to 6 years. In some circumstances, however, the credit is not based on the cost of the property, but on its basis as specially defined. Moreover, regulated public utilities are granted a credit equal to only $\frac{3}{7}$ of the credit otherwise computed, presumably on the theory that the assurance of a fair return on their investment reduces the need for a tax incentive.

If the credit exceeds $25,000 in any year, the taxpayer may be required by §46(a)(2) and §46(b) to use part or all of the excess as a carryback to an earlier year or as a carryover to a later year rather than utilizing it in the year it arises.

If there is an early disposition of property qualifying for the investment credit (e.g., if property with an estimated useful life of 8 years or more is retired from service in 5 years), the credit is "recaptured" by §47 to the extent of the reduction that would have resulted if the actual life had been used in computing the credit instead of the estimated life. (In the parenthetical example, only one third of the basis would have qualified on the assumption of a 4 to 6 years useful life, instead of the full basis.) The "recapture" takes the form of an additional tax in the year of disposition. A number of events that do not produce taxable income or deductible loss can cause a recapture of the investment credit, e.g., gifts and corporate distributions. Moreover, part or all of the credit may be recaptured even if the taxpayer continues to be the owner of the property, if he transfers it to a predominantly foreign use or uses in a way that would not have qualified for the credit at the outset.

See Wilkinson, The Investment Tax Credit Under the Revenue Act of 1962, 42 Texas L. Rev. 498 (1964).

4. *Special incentives to investment: rapid amortization of war facilities.* A more drastic method of encouraging new investment was in force for defense and war construction dur-

ing World War II. Under §124 of the 1939 Code, the taxpayer was allowed to amortize over a period of 60 months the cost of any plant or equipment that was certified by an appropriate war agency as necessary to national defense. War production facilities could thus be constructed or acquired with assurance that the cost (or such part as was certified for amortization by the agency) could be written off during a period of high profits, and against income that would otherwise be taxed at high rates, even though the facilities might continue to be useful at the end of the 5-year period. See United States v. Allen-Bradley Co., 352 U.S. 302 (1957). A similar provision was enacted in 1950 (§168 of the 1954 Code), which was extensively used during the Korean War. By virtue of a 1957 amendment, §168 was made applicable only to a limited group of "emergency facilities," primarily for research, development, and atomic equipment for the Department of Defense and the Atomic Energy Commission, and its use terminated in 1959. §168(a) and (i). See Report on 5-Year Amortization of Emergency Defense Facilities Under Section 168 of the Internal Revenue Code of 1954, Joint Committee on Internal Revenue Taxation, 84th Cong., 2d Sess. (1956); Schlaifer, Butters, and Hunt, Accelerated Amortization, 29 Harv. Bus. Rev. 113 (May, 1951).

A primitive antecedent of the "recapture" rule for the 1962 investment credit may be found in §1238, providing that the taxpayer's gain on the sale or exchange of property that qualified for rapid amortization under §168 must be reported as ordinary income (rather than as capital gain) to the extent that the rapid amortization exceeded the amount that would have been deducted under a normal method of depreciation. For another, and closer parallel, see the 1962 and 1964 rules for recapture of "excessive" depreciation under §1245 and §1250, infra pages 561-563.

5. *Useful life.* As stated in the extract from Bulletin F, supra page 292, depreciation is ordinarily dependent upon the "expected useful life" of the depreciable property. (A special problem, arising when the taxpayer customarily disposes of depreciable property substantially before the expiration of its useful life, is considered in Massey Motors, Inc. v. United States, infra p. 300). As a guide to taxpayers and internal revenue agents, Bulletin F itself contained estimates of the useful lives of a large number of classes of property used in many industries; although not binding, these estimates tended to be widely used because they offered a method of avoiding arguments over what at best was only an informed guess about the future. The estimates in Bulletin F were widely criticized, however, as outmoded in an industrial society in which technology changes more rapidly than when the estimates were compiled.

In 1962, the Internal Revenue Service promulgated Rev. Proc. 62-21, 1962-2 C.B. 418, drastically revising the useful lives to be recognized as normal hereafter. The new "guidelines," which unlike Bulletin F apply to broad classes of equipment (e.g., office equipment regardless of industry, all equipment used in providing personal services, all equipment in manufacturing plastic products, etc.), are 30 to 40 per cent shorter on the average than those of Bulletin F. The taxpayer is permitted to use the new guidelines for a period of three years as a matter of right; thereafter, they are to be accepted "unless there are clear indications that the taxpayer's replacement practices do not conform with the depreciation claimed and are not even showing a trend in that direction." Revenue Procedure 62-21 provides an objective method (the "reserve ratio") of establishing that continued use of the new lives, or the adoption of shorter lives, is proper — in essence, the reserve ratio measures the relationship between the lives used by the taxpayer in claiming depreciation and the extent to which he is in fact replacing the depreciable equipment, and it includes a margin of tolerance to permit the depreciation to be taken as much as 20 per cent faster than equipment is replaced.

For more on the 1962 guidelines, see Goldstein, Developments in Tax Depreciation and Related Areas, 49 Va. L. Rev. 411 (1963).

Taxpayers are not required to use the 1962 guidelines; shorter lives are permissible if they can be justified, and longer lives are equally permissible if the facts warrant. For the procedures applicable in reviewing depreciation deductions claimed by taxpayers who choose not to avail themselves of the 1962 guidelines, see Rev. Ruls. 90 and 91, 1953-1 C.B. 43 and 44. These pre-1962 procedures are also applicable to assets depreciated under methods that do not measure the asset's life in terms of years, such as the unit-of-production method (Bulletin F, supra) and the "income forecast" method sanctioned for television films by Rev. Rul. 60-358, 1960-2 C.B. 68 (entire income to be derived from film

is estimated in advance, and appropriate fraction of the cost is deducted each year as income is realized).

See also §167(d), added by the 1954 Code, permitting the government and the taxpayer to enter into written agreements relating to the useful life and rate of depreciation of any property, which "shall be binding on both the taxpayer and the Secretary in the absence of facts or circumstances not taken into consideration in the adoption of such agreement."

6. *Salvage value.* The amount to be depreciated over the asset's useful life is not necessarily its cost (or other basis), but the difference between that amount and its estimated salvage value. See page 305 infra.

7. *Changes in asset's useful life, salvage value, or basis.* For the adjustments that are required if the asset's useful life or salvage value are re-estimated, or if an error in the determination of its basis is corrected, see page 453 infra.

8. *Extraordinary obsolescence.* Section 167(a) speaks of a reasonable allowance for the exhaustion of property, "including a reasonable allowance for obsolescence." Since the useful life of depreciable property depends on "the normal progress of the art, economic changes, inventions and current developments within the industry and the taxpayer's trade or business," as well as on the property's physical characteristics, the deduction for depreciation includes a built-in allowance for so-called "normal obsolescence." Regs. §1.167(a)-1(b) and §1.167(a)-9; see also the discussion in Bulletin F, supra. For an example, see Adda, Inc. v. Commissioner, 9 T.C. 199 (1947), where the taxpayer was permitted to depreciate a building in Times Square, New York City, over a period of 21 years, although its physical life would be much longer, because "we think it reasonable under the evidence to determine that, within a period of 21 years . . . the present building will be removed and a much taller one erected that will produce revenue more in keeping with the value of the lot."

Although Regs. §1.167(a)-9 provides that the originally estimated useful life of an asset may be reduced on a showing that obsolescence is proceeding more rapidly than had been predicted, taxpayers have not been very successful in establishing a right to such special or extraordinary obsolescence. See, for example, Southeastern Building Corp. v. Commissioner, 148 F.2d 879 (5th Cir. 1945). A deduction was allowed in Hazeltine Corp. v. Commissioner, 89 F.2d 513 (3d Cir. 1937), upon a showing that certain patents had "ceased to have any further practical utility or substantial earning power" prior to the end of their legal lives, by reason of a change in the art. What if the patents continued to have minor value by protecting the taxpayer's monopoly in manufacturing repair parts for equipment, although new equipment was no longer being manufactured because of technological changes? Is there any justification for demanding a very high degree of proof, or even of insisting upon total loss of utility, as a condition to the allowance for "extraordinary obsolescence" when deductions for "normal obsolescence" are granted upon less proof? See generally Green, What Deductions for Obsolescence? 9 N.Y.U. Inst. on Fed. Taxation 701 (1951); Keller St. Development Co. v. Commissioner, 323 F.2d 166 (9th Cir. 1963).

9. *Differences between tax returns and financial statements in respect of depreciation.* If a business depreciates its assets for income tax purposes faster than it depreciates them in financial statements to shareholders (or, in the case of regulated industries, in financial statements prepared for rate-making agencies), its "tax return income" will be lower than its "financial statement income" in early years, but higher in later years. For this reason, the Securities and Exchange Commission has expressed the view that if the amounts are material, investors may be misled: in the early years, when "financial statement income" is high but income tax liabilities low, investors may become too optimistic about the company's financial position, and they will have a rude awakening in later years, when the income tax liabilities will be greater than the "financial statement income" anticipated for those years would seem to warrant. The SEC has announced that the proper method of reflecting this disparity is by charging income in the early years with the tax reduction resulting from the accelerated depreciation method used for tax purposes, and restoring this amount to income in the later years. Securities Act of 1933, Release No. 4191 (Feb. 29, 1960); see also Securities Act Release No. 4574 (Jan. 10, 1963) (re accounting for investment credit); Dean and Harriss, Railroad Accounting Under the New Depreciation Guidelines and Investment Tax Credit, 1963 Accounting Rev. 230.

For the effect of accelerated depreciation on the rates charged by public utilities, see

Swiren, Accelerated Depreciation Tax Benefits in Utility Rate Making, 28 U. of Chi. L. Rev. 629 (1961); Federal Power Commission, Alabama-Tennessee Natural Gas Co. (Op. No. 417, 1964).

10. *Depreciation based on replacement cost.* In recent years, especially since the end of World War II, there have been a number of proposals for acknowledging in corporate financial statements that depreciation reserves based upon cost are inadequate to cover the replacement cost of equipment and plant as they are retired or scrapped. One method is to make an appropriation of earned surplus to a reserve for the excess of replacement cost over depreciation reserves based on cost. Another, more controversial, is to increase the depreciation deductions themselves, thus reflecting a smaller earned income in reports to stockholders, employees, government agencies, and the public. The income tax return, however, must still be prepared with depreciation based upon cost, and thus taxable income will exceed the income reported for other purposes. Finally, not surprisingly, it has been urged that taxable income should be adjusted to reflect replacement costs. This drastic proposal is extensively discussed in Brown, Depreciation Adjustments for Price Changes (1952). For a consideration of this and other problems in the relation of depreciation to investment, see Joint Committee on the Economic Report, Factors Affecting Volume and Stability of Private Investment, 81st Cong., 1st Sess. 158-197 (1949).

11. *References.* For the economic significance of the depreciation deduction, see the papers by various authors in 2 Tax Revision Compendium 793-931 (House Ways and Means Committee, 1959), Federal Tax Policy for Economic Growth and Stability 495-545 (Joint Committee on the Economic Report, 1955), and Depreciation and Taxes (Tax Institute, 1959).

See also Sporn, Some Contributions of the Income Tax Law to the Growth and Prevalence of Slums, 59 Colum. L. Rev. 1026 (1959); Blum and Dunham, Income Tax Law and Slums: Some Further Reflections, 60 id. 447; Sporn, Slums and the Income Tax: A Brief Rejoinder, id. 454.

MASSEY MOTORS, INC. v. UNITED STATES
364 U.S. 92 (1960)

MR. JUSTICE CLARK delivered the opinion of the Court.

These consolidated cases involve the depreciation allowance for automobiles used in rental and allied service, as claimed under [§167(a)(1)], which permits the deduction for income tax purposes of a "reasonable allowance for the exhaustion, wear and tear . . . of property used in the trade or business." The applicable Treasury Regulations 111, §29.23(l)-1, defines such allowance to be "that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan . . . whereby the aggregate of the amounts so set aside, plus the salvage value, will, at the end of the useful life of the depreciable property, equal the cost or other basis of the property." * The Courts of Appeals have divided on the method of depreciation which is permissible in relation to such assets, and we therefore granted certiorari to resolve this conflict. 361 U.S. 810, 812. We have concluded that the reasonable allowance for depreciation of the property in question used in the taxpayer's business is to be calculated over the estimated useful life of the asset while actually employed by the taxpayer, applying a depreciation base of the cost of the property to the taxpayer less its resale value at the estimated time of disposal.

In No. 143, Commissioner v. R. H. and J. M. Evans, the taxpayers are husband and wife. In 1950 and 1951, the husband, Robley Evans, was engaged in the business of leasing new automobiles to Evans U-Drive, Inc., at the rate of $45 per car per month. U-Drive in turn leased from 30% to 40% of the cars to its customers for long terms ranging from 18 to 36 months, while the remainder were rented to the public on a call basis for shorter periods. Robley Evans normally kept in

* The corresponding current provision, Regs. §1.167(a)-1(a), is virtually identical. — ED.

stock a supply of new cars with which to service U-Drive and which he purchased at factory price from local automobile dealers. The latest model cars were required because of the demands of the rental business for a fleet of modern automobiles.

When the U-Drive service had an oversupply of cars that were used on short-term rental, it would return them to the taxpayer and he would sell them, disposing of the oldest and least desirable ones first. Normally the ones so disposed of had been used about 15 months and had been driven an average of 15,000 to 20,000 miles. They were ordinarily in first-class condition. It was likewise customary for the taxpayer to sell the long-term rental cars at the termination of their leases, ordinarily after about 50,000 miles of use. They also were usually in good condition. The taxpayer could have used the cars for a longer period, but customer demand for the latest model cars rendered the older styles of little value to the rental business. Because of this, taxpayer found it more profitable to sell the older cars to used car dealers, jobbers or brokers at current wholesale prices. Taxpayer sold 140 such cars in 1950 and 147 in 1951. On all cars leased to U-Drive, taxpayer claimed on his tax returns depreciation calculated on the basis of an estimated useful life of four years with no residual salvage value. The return for 1950, for example, indicated that each car's cost to taxpayer was around $1,650; after some 15 months' use he sold it for $1,380; he charged depreciation of $515 based on a useful life of four years, without salvage value, which left him a net gain of $245, on which he calculated a capital gains tax. In 1951 the net gain based on the same method of calculation was approximately $350 per car, on which capital gains were computed. The Commissioner denied the depreciation claims, however, on the theory that useful life was not the total economic life of the automobile (i.e., the four years claimed), but only the period it was actually used by the taxpayer in his business; and that salvage value was not junk value but the resale value at the time of disposal. On this basis he estimated the useful life of each car at 17 months and salvage value at $1,325; depreciation was permitted only on the difference between this value and the original cost. The Tax Court accepted the Commissioner's theory but made separate findings. The Court of Appeals reversed, holding that useful life was the total physical or economic life of the automobiles — not the period while useful in the taxpayer's business. 264 F.2d 502.

In No. 141, Massey Motors, Inc. v. United States, the taxpayer, a franchised Chrysler dealer, withdrew from shipments to it a certain number of new cars which were assigned to company officials and employees for use in company business. Other new cars from these shipments were rented to an unaffiliated finance company at a substantial profit.

The cars assigned to company personnel were uniformly sold at the end of 8,000 to 10,000 miles' use or upon receipt of new models, whichever was earlier. The rental cars were sold after 40,000 miles or upon receipt of new models. For the most part, cars assigned to company personnel and the rental cars sold for more than they cost the taxpayer. During 1950 and 1951, the tax years involved here; the profit resulting from sale of company personnel cars was $11,272.80 and from rental cars, $525.84. The taxpayer calculated depreciation on the same theory as did taxpayer Evans, computing the gains on the sales at capital gain rates with a basis of cost less depreciation. The Commissioner disallowed the depreciation claimed. After paying the tax and being denied a refund, the taxpayer filed this suit. The trial court decided against the Commissioner. The Court of Appeals for the Fifth Circuit, however, reversed, sustaining the Commissioner's views as to the meaning of useful life and salvage value. 264 F.2d 552.

First, it may be well to orient ourselves. The Commissioner admits that the

automobiles involved here are, for tax purposes, depreciable assets rather than ordinary stock in trade. Such assets, employed from day to day in business, generally decrease in utility and value as they are used. It was the design of the Congress to permit the taxpayer to recover, tax free, the total cost to him of such capital assets; hence it recognized that this decrease in value — depreciation — was a legitimate tax deduction as business expense. It was the purpose of [§167(a)] and the regulations to make a meaningful allocation of this cost to the tax periods benefitted by the use of the asset. In practical life, however, business concerns do not usually know how long an asset will be of profitable use to them or how long it may be utilized until no longer capable of functioning. But, for the most part, such assets are used for their entire economic life, and the depreciation base in such cases has long been recognized as the number of years the asset is expected to function profitably in use. The asset being of no further use at the end of such period, its salvage value, if anything, is only as scrap.

Some assets, however, are not acquired with intent to be employed in the business for their full economic life. It is this type of asset, where the experience of the taxpayers clearly indicates a utilization of the asset for a substantially shorter period than its full economic life, that we are concerned with in these cases. Admittedly, the automobiles are not retained by the taxpayers for their full economic life and, concededly, they do have substantial salvage, resale or second-hand value. Moreover, the application of the full-economic-life formula to taxpayers' businesses here results in the receipt of substantial "profits" from the resale or "salvage" of the automobiles, which contradicts the usual application of the full-economic-life concept. There, the salvage value, if anything, is ordinarily nominal. Furthermore, the "profits" of the taxpayers here are capital gains and incur no more than a 25% tax rate.* The depreciation, however, is deducted from ordinary income. By so translating the statute and the regulations, the taxpayers are able, through the deduction of this depreciation from ordinary income, to convert the inflated amounts from income taxable at ordinary rates to that taxable at the substantially lower capital gains rates. This, we believe, was not in the design of Congress.

It appears that the governing statute has at no time defined the terms "useful life" and "salvage value." In the original Act, Congress did provide that a reasonable allowance would be permitted for "wear and tear of property *arising out of its use or employment in the business.*" (Emphasis added.) Act of Oct. 3, 1913, 38 Stat. 167. This language, particularly that emphasized above, may be fairly construed to mean that the wear and tear to the property must arise from its use *in the business* of the taxpayer — i.e., useful life is measured by the use in a taxpayer's business, not by the full abstract economic life of the asset in any business. In 1918, the language . . . was amended so that the words emphasized above would read "used in the trade or business," §214(a)(8), Revenue Act of 1918, 40 Stat. 1067, and the section carried those words until 1942. Meanwhile, Treas. Reg. 45, Art. 161, was promulgated in 1919 and continued in substantially the same form until 1941. It provided:

> The proper allowance for such depreciation of any property used in the trade or business is that amount which should be set aside for the taxable year in accordance with a consistent plan by which the aggregate of such amounts for the *useful life of the property in the business* will suffice, with the *salvage value, at the end of such useful life* to provide in place of the property its cost. . . . [Emphasis added.]

It, too, may be construed to provide that the use and employment of the property *in the business* relates to the trade or business of the taxpayer — not, as is con-

* See page 306 infra. — ED.

tended, to the type or class of assets subject to depreciation. The latter contention appears to give a strained meaning to the phrase. This might be particularly true of the language in Treasury Regulations 103, promulgated January 29, 1940, under the Internal Revenue Code of 1939. Its §19.23(1)-1 and §19.23(1)-(2) complement each other and seem to advise the taxpayer how to compute depreciation and what property is subject to it. The first section not only describes the proper allowance, but sets out how it is to be computed so that depreciation "plus the salvage value, will, *at the end of the useful life of the property in the business,* equal the cost. . . ." (Emphasis added.) The second section specifically defines the type of assets to which the depreciation allowance is applicable. It may be said that the taxpayers' arguments as to this regulation fail completely, since it not only specifically provides that "useful life" relates to property while used "in the business," but also details the type or class of property included within the allowance. It appears to cut from under the taxpayers the argument that the term "property used in the trade or business" relates to the type or class of assets that are included within the allowance. It would be strange to say that both of these sections of Regulations 103 defined the same thing, viz., the type or class of assets subject to depreciation. On the other hand, the taxpayers point out that Regulations 111, issued in 1942, deleted the words "property in the business" from §19.23(1)-1 and substituted the term "depreciable property." This might, as taxpayers claim, establish that the phrase "property used in the trade or business" merely referred to the type of property involved. Certainly when considered in isolation, this appears to be true. But the "depreciable property" phrase does refer back to the earlier identical language, still remaining in the section, of "property used in the trade or business." It does appear, however, as the Court of Appeals in No. 141, *Massey,* held, that this substitution was made because Congress expanded the depreciation allowance provision . . . to include property held for the production of income.* The change in the Regulations only conformed it to this amendment of the basic statute.

It is true, as taxpayers contend and as we have indicated, that the language of the statute and the regulations as we have heretofore traced them may not be precise and unambiguous as to the term "useful life." It may be that the administrative practice with regard thereto may not be pointed to as an example of clarity, and that in some cases the Commissioner has acquiesced in inconsistent holdings. But from the promulgation of the first regulation in 1919, he has made it clear that salvage had some value and that it was to be considered as something other than zero in the depreciation equation. In fact many of the cases cited by the parties involved controversies over the actual value of salvage, not as scrap but on resale. The consistency of the Commissioner's position in this regard is evidenced by the fact that the definition of salvage as now incorporated in the regulations as identical with that claimed as least since 1941. In the light of this, it appears that the struggle over the term "useful life" takes on less practical significance, for, if salvage is the resale value and a deduction of this amount from cost is required, the dollar-wise importance to the taxpayer of the breadth in years of "useful life" is diminished. It is only when he can successfully claim that salvage means junk and has no value that an interpretation of "useful life" as the functional, economic, physical life of the automobile brings money to his pocket. Moreover, in the consideration of the appropriate interpretation of the term, it must be admitted that there is administrative practice and judicial decision in its favor, as we shall point out.† Furthermore, as we have said, Congress intended by the de-

* By the enactment in 1942 of what is now §167(a)(2), parallel to the enactment of §212(1) and (2). — ED.

† The Court's account of the administrative practice and its citation of cases are omitted. — ED.

preciation allowance not to make taxpayers a profit thereby, but merely to protect them from a loss. The concept is, as taxpayers say, but an accounting one and, we add, should not be exchangeable in the market place. Accuracy in accounting requires that correct tabulations, not artificial ones, be used. Certainly it is neither accurate nor correct to carry in the depreciation equation a value of nothing as salvage on the resale of the automobiles, when the taxpayers actually received substantial sums therefor. On balance, therefore, it appears clear that the weight of both fairness and argument is with the Commissioner. . . .

Finally, it is the primary purpose of depreciation accounting to further the integrity of periodic income statements by making a meaningful allocation of the cost entailed in the use (excluding maintenance expense) of the asset to the periods to which it contributes. This accounting system has had the approval of this Court since United States v. Ludey, 274 U.S. 295, 301 (1927), when Mr. Justice Brandeis said, "The theory underlying this allowance for depreciation is that by using up the plant, a gradual sale is made of it." The analogy applies equally to automobiles. Likewise in Detroit Edison Co. v. Commissioner, 319 U.S. 98, 101 (1943), this Court said:

> The end and purpose of it all [depreciation accounting] is to approximate and reflect the financial consequences to the taxpayer of the subtle effects of time and use on the value of his capital assets. For this purpose it is sound accounting practice annually to accrue . . . an amount which at the time it is retired will with its salvage value replace the original investment therein.

Obviously a meaningful annual accrual requires an accurate estimation of how much the depreciation will total. The failure to take into account a known estimate of salvage value prevents this, since it will result in an understatement of income during the years the asset is employed and an overstatement in the year of its disposition. The practice has therefore grown up of subtracting salvage value from the purchase price to determine the depreciation base. On the other hand, to calculate arbitrarily the expected total expense entailed by the asset on the false assumption that the asset will be held until it has no value is to invite an erroneous depreciation base and depreciation rate, which may result in either an over- or an under-depreciation during the period of use. If the depreciation rate and base turn out to reflect the actual cost of employing the asset, it will be by accident only. The likelihood of presenting an inaccurate picture of yearly income from operations is particularly offensive where, as here, the taxpayers stoutly maintain that they are only in the business of renting and leasing automobiles, not of selling them.* The alternative is to estimate the period the asset will be held in the business and the price that will be received for it on retirement. Of course, there is a risk of error in such projections, but prediction is the very essence of depreciation accounting. Besides, the possibility of error is significantly less where probabilities rather than accidents are relied upon to produce what is hoped to be an accurate estimation of the expense involved in utilizing the asset. Moreover, under a system where the real salvage price and actual duration of use are relevant, to further insure a correct depreciation base in the years after a mistake has been discovered, adjustments may be made when it appears that a miscalculation has been made.

Accounting for financial management and accounting for federal income tax purposes both focus on the need for an accurate determination of the net income from operations of a given business for a fiscal period. The approach taken by

* In claiming that their profit on selling the vehicles was capital gain, the taxpayers must establish that they were held for rental, and not for sale to customers in the ordinary course of business. (See page 559 infra.) — Ed.

the Commissioner computes depreciation expense in a manner which is far more likely to reflect correctly the actual cost over the years in which the asset is employed in the business.

We therefore conclude that the Congress intended that the taxpayer should, under the allowance for depreciation, recover only the cost of the asset less the estimated salvage, resale or second-hand value. This requires that the useful life of the asset be related to the period for which it may reasonably be expected to be employed in the taxpayer's business. Likewise salvage value must include estimated resale or second-hand value. It follows that No. 141, Massey Motors, Inc. v. United States, must be affirmed, and No. 143, Commissioner v. R. H. and J. M. Evans, reversed.

It is so ordered.

[Mr. Justice Harlan, joined by Mr. Justice Whittaker, Mr. Justice Stewart, and Mr. Justice Douglas, dissented. They found the statute and Regulations inconclusive, and their examination of the Commissioner's position as reflected in his stand in litigated cases led them to the conclusion that his "pre-1956 position on 'useful life' was flatly opposed to that which he now takes." Acknowledging that the 1956 position could be properly applied prospectively, they would not allow it to be applied to pre-1956 years.]

NOTE

1. *Salvage value.* After the decision of the Supreme Court, the *Massey Motors* case was remanded to the District Court for a determination of the salvage value of the automobiles. The court held that the retail value of the cars at the time of disposal, not their wholesale value at that time, was controlling, in the light of the taxpayer's practice of selling the cars at retail.

In a companion case, Hertz Corp. v. United States, 364 U.S. 122, the Court held that a taxpayer using the declining balance method of computing depreciation under §167(b)(2) could not depreciate an asset below its salvage value; the taxpayer had contended that the "mathematical residue" that is always left in the declining balance method constitutes a built-in salvage value so that no further computation of salvage value need be made. Mr. Justice Douglas dissented.

In 1962, §167(f) was enacted, to permit the salvage value of personal property with an estimated useful life of 3 years or more to be reduced, if the taxpayer chooses, by an amount not in excess of 10 per cent of the asset's basis. Under this provision, salvage value can be disregarded if it amounts to 10 per cent of the asset's basis or less; this simplifies the computation of the depreciation deduction, and slightly increases the amount that may be deducted, at the cost of increasing the gain (or decreasing the loss) when the property is disposed of.

2. *Relation of depreciation to gain on disposition of depreciable assets.* The corollary of higher depreciation deductions is more gain (or less loss) if the property is disposed of before it is fully depreciated. This is because the property's "adjusted basis" for determining gain or loss on a sale or other disposition is cost less depreciation. Thus if the equipment used as an example in the table of depreciation, supra page 296, was sold at the end of the first year, its adjusted basis would be $1900 if depreciated on a straight line basis, but only $1680 if depreciation had been calculated by the 20 per cent declining balance method. A sale for $1950 would, therefore, produce income of $50 or $270 respectively, while a sale at $1500 would produce loss of $400 or $180.

A bird in the hand is not necessarily better than two in the bush. Can a taxpayer, recognizing this, forgo current depreciation deductions in order to retain a higher "adjusted basis" against the year when the asset is ultimately sold? No, because in computing the "adjusted basis" he must reduce his cost by any depreciation that was "allowable" in past years, whether he took it or not. §1016(a)(2). Moreover, if he took more than he was entitled to, that too must be applied against the cost of the asset unless the excessive depreciation was of no "tax benefit" when taken. This last qualification

is a legislative overruling of Virginian Hotel Corp. v. Helvering, 319 U.S. 523 (1943); see §1016(a)(2)(A) and (B) and §1020.

One of the factors of importance in this area, the full significance of which will appear more clearly after Chapter 6 has been studied, is that depreciation deductions are applied against ordinary income, whereas the countervailing profit on a sale (assuming the property is sold for more than its "adjusted basis") may be taxed as capital gain, at a more lenient rate. Thus the taxpayer may be tempted to "trade" deductions against ordinary income for capital gain even when it is recognized that high current depreciation will have the effect of increasing the profit (or decreasing the loss) on disposition of the property. This opportunity of obtaining ordinary deductions at the cost of later capital gain was fundamental to the *Massey Motors* case, but since 1962 it has been drastically restricted by the enactment of §1245. This provision (discussed further infra p. 561) provides that gain on a sale of depreciable personal property must be reported as ordinary income, rather than as capital gain, to the extent of the post-1961 depreciation deductions attributable to the property. Because excessive depreciation will thus be "recaptured" as ordinary income, the Internal Revenue Service was willing to promulgate the shortened new guidelines for depreciable property described supra page 298; and the enactment in 1962 of §167(f) (allowing salvage value to be reduced by an amount up to 10 per cent of the property's basis) should also be viewed as an outgrowth of §1245.

3. *Denial of depreciation in year asset is sold.* Is there any justification for a depreciation deduction in the year depreciable property is sold, if the sales price equals or exceeds its adjusted basis? A deduction was denied in Cohn v. United States, 259 F.2d 371 (6th Cir. 1958), where the assets were sold near the end of their useful life and no salvage value had been taken into account and in Fribourg Navigation Co., Inc. v. Commissioner, ¶62,290 P-H Memo T.C., depreciation for the year of sale was denied even though reasonable salvage values had been used and the sales price had been inflated by unforeseen circumstances; but see Motorlease Corp. v. United States, 215 F. Supp. 356 (D. Conn. 1963) (depreciation allowed in year of sale, where reasonable useful life and salvage value were used in computing deduction). Does *Massey Motors* shed any light on this problem?

WORLD PUBLISHING CO. v. COMMISSIONER

299 F.2d 614 (8th Cir. 1962)

Before VOGEL, VAN OOSTERHOUT and BLACKMUN, Circuit Judges.

BLACKMUN, Circuit Judge.

This is a petition for review of a decision of the Tax Court approving the Commissioner's determination of deficiencies in the taxpayer's income taxes for the respective calendar years 1952, 1953 and 1954. 35 T.C. 7. The taxpayer, World Publishing Company, is a Nebraska corporation on the accrual basis. Its taxable year is the calendar year. It is engaged primarily in the newspaper business and it publishes the Omaha World Herald.

The issue before us concerns the taxpayer's right to a deduction for depreciation of a portion of the price it paid when it purchased improved real estate subject to an outstanding lease to the tenant who had built the building on the property.

The facts are not in dispute: On June 29, 1928, George Warren Smith, Inc., was the owner of two mid-block lots in downtown Omaha. On that date Smith leased those lots to Farnam Realty Corporation. The lease was for a term of fifty years from July 1, 1928, and called for annual rentals averaging $28,500 but varying between $25,000 and $32,500 for specified decades. It required Farnam immediately to construct a "six (6) story, or more, and basement building" on the property at a cost of not less than $250,000. Farnam complied with this requirement.

On January 4, 1950, the taxpayer purchased as an investment Smith's entire interest in the property, including the lease, for $700,000. The deed recited that

it was subject to the lease to Farnam. The parties have stipulated that "the remaining useful life of the building in January, 1950, was not greater than the unexpired term of the lease."

In its income tax return for each of the years in question the taxpayer asserted a deduction of $10,547.92 for "Depreciation and Amortization." This amount was determined by spreading $300,000 (constituting that part of its purchase price which the taxpayer claimed was allocable to the building) over the remaining years of the still outstanding lease. The Commissioner disallowed this deduction.

Certain other provisions of the lease of June 29, 1928, from Smith, as lessor, to Farnam, as lessee, may be pertinent.

1. The parties agreed that "Any and all buildings erected on the said premises under covenants by, or permission granted, to the Lessee shall, at and upon the construction thereof, be and become a part of the realty and upon the termination of this lease, by the expiration of its term or by default or otherwise, any and all such buildings and improvements shall pass to and remain the property of the Lessor."

2. The lessee agreed to pay all taxes and assessments upon the land or the improvements or "which the Lessor shall be required to pay by reason of or on account of its interest in said land or improvements, or its interest in or under this lease, except estate, inheritance, and income taxes."

3. The lessee agreed, before beginning construction of the building, to submit all plans and specifications to the lessor for approval. The lessor could reject or amend these.

4. The lessee agreed to post security with a named Omaha bank for the construction of the building, and the lessor possessed rights, in the event of default in the construction, to call upon that security.

5. The lessee agreed at its expense to procure fire and tornado insurance for the full insurable value of the improvements, with the lessor having the right to attach any mortgage clause its mortgagee might require; to buy plate glass and explosion insurance "in such form as to furnish protection to the Lessor and Lessee"; to buy workmen's compensation insurance "for the protection of the Lessor"; and to buy upon demand "such other reasonable insurance protection as the Lessor may require." The lessee agreed to carry rental interruption insurance in its own favor.

6. The lessee agreed, in case of damage or destruction of the building or any part thereof during the lease, to repair and restore it; it was then entitled to the insurance collected. If, however, the damage or destruction occurred on or after noon of July 1, 1958, the lessee's obligation to restore, in the absence of default in its insurance covenants, was limited to the insurance received.

7. The lessee agreed that upon the completion of the building it "shall not be altered in any manner whatsoever" without the written consent of the lessor, except by governmental authority and except that the lessee could make at its own expense alterations and improvements "in a first-class manner" without such consent if the cost did not exceed $10,000. It was stated that it was "the intention that the building shall at all times be kept in such physical condition that excessive depreciation shall not occur."

8. The lessee agreed at its own cost to maintain the building, the premises and the fixtures in good condition and repair; to permit inspection by the lessor; and to permit the lessor to enter the premises and effect repairs when the lessee failed to keep its repair covenant.

9. The lessee agreed that the lessor could, up to a stated percentage of the

ity, a line of cases, including one of our own, concerning the situation where a taxpayer, through *inheritance* or *devise* from a deceased lessor, comes into the ownership of tenant-improved property subject to an outstanding lease: First Nat. Bank of Kansas City v. Nee, 8 Cir., 1951, 190 F.2d 61, with Judge Collet concurring in the result; Goelet v. United States, 2 Cir., 1959, 266 F.2d 881; Schubert v. Commissioner, 4 Cir., 1961, 286 F.2d 573, cert. den. 366 U.S. 960; Friend v. Commissioner, 7 Cir., 1941, 119 F.2d 959, cert. den. 314 U.S. 673; Commissioner v. Moore, 9 Cir., 1953, 207 F.2d 265, cert. den. 347 U.S. 942; Commissioner v. Pearson, 5 Cir., 1951, 188 F.2d 72, cert. den. 342 U.S. 861; and Albert L. Rowan, 1954, 22 T.C. 865. To the same effect is Rev. Rul. 55-89, 1955-1 C.B. 284.

The theories which find expression in these cases are (a) that the decedent had — and his successor has — no investment in the wasting asset and (b) that the heir or devisee could acquire no different interest than was possessed by the decedent. "The major thrust of the statute is toward an allowance for recovery of investment in a wasting asset." *Goelet* (District Court), p. 307 of 161 F. Supp. "Appellants fail to show how a depreciable interest in the building was supplied to them . . ." *Goelet* (2 Cir.), p. 882 of 266 F.2d. "All she [the taxpayer] could acquire by inheritance from her mother, the testatrix, was such interest as her mother had to devise." *Schubert*, p. 579 of 286 F.2d.

Are these inheritance-or-devise cases cited by the Commissioner proper or helpful precedent for a situation involving acquisition by purchase? In determining this, some comments about the death cases are perhaps in order:

A. They have provoked substantial criticism. See Rabkin and Johnson, Federal Income, Gift and Estate Taxation, Vol. 2, §45.09(2) and (3); Lurie, Depreciating Structures Bought Under Long Leases: An Adventure in Blunderland, New York University 18th Annual Institute on Federal Taxation, 1960, pp. 43, 60-62; Rubin, Depreciation of Property Purchased Subject to a Lease, 65 Harvard Law Review, 1952, pp. 1134, 1137, 1145-1146; dissenting opinion of Judge Opper, joined by Judge Drennen, in *Schubert*, supra, pp. 1055, et seq., of 33 T.C. See Mertens, The Law of Federal Income Taxation, Vol. 4, §23.90, pp. 187-188.

B. The facts of certain of these cases possess some significance. In *Goelet* the district court emphasized that, although the taxpayer by the terms of the lease may have had "technical legal title to the building," this was not determinative but "beneficial ownership" was. In *Schubert* it appears from the majority opinion of the Tax Court, p. 1049 of 33 T.C., that under the lease the improvement was to become the property of the lessor only "upon the termination of the lease." In *Friend*, too, it is clear from the Board's opinion, p. 771 of 40 B.T.A., that the taxpayers "did not own the buildings" and did not "even claim that they are entitled to an allowance for depreciation in respect of the buildings." In *Pearson*, *Moore*, and *Nee* the appellate courts all concluded that no part of the estate tax valuation, which constituted basis, was attributable to the improvements and that the taxpayer's case, depending, as it did, on a basis to depreciate, consequently failed. And in our *Nee* case we concluded that the rentals were attributable solely to the land; that the building was not held by the testamentary trustee for the production of income; that the tenant had the right to remove the building and replace it; and that because of this right the title to the building may have been in the lessee (the trial court had held specifically that under the terms of the lease title to the building was in the lessee: D.C., 85 F. Supp. 840, 843; D.C., 92 F. Supp. 328, 329).

C. An alternative and forceful argument made by the taxpayer in some of these cases is that he is entitled to claim a deduction for amortization of the "premium value" of the lease. The argument was rejected in *Schubert* (4 Cir

ground value, borrow money on the security of the property and secure it by mortgages or deeds of trust "which shall constitute a lien on the grounds and buildings prior to the claim of the Lessee" or its assigns.

10. The lessee had the right to assign, if it was not in default, but was not thereby released from its obligations under the lease unless the lessor so consented in writing.

11. The lessee agreed that at the termination of the lease it would "surrender the possession of the demised premises to the Lessor with the buildings and improvements thereon without delay."

The taxpayer in fact has received and retained the insurance policies required by the lease. These are issued in the name of the taxpayer as the insured.

There is substantial, and uncontradicted, evidence in the record to support the $300,000 figure. A qualified appraiser testified that at the time of purchase the fair and reasonable value of the ground alone was $400,000 and the fair and reasonable value of the building alone was around $300,000. These valuation allocations correspond, too, with the full valuations thereof used for real estate assessment purposes at the time of the purchase. The witness also testified that in his opinion the probable value of the land alone at the expiration of the lease in 1978 would be approximately $400,000.

On these facts, uninfluenced by any decided lease cases, it would seem clearly to follow that the taxpayer is entitled to a deduction, under §167(a), for depreciation of the $300,000 portion of its 1950 purchase price allocable to the improvements on the real estate in question. See Detroit Edison Co. v. Commissioner, 1943, 319 U.S. 98, 101. The building, as well as the land, was acquired and held by the taxpayer "for the production of income." The taxpayer's interest was one acquired by purchase and was not in any sense a derivative right acquired without investment on its part. By the stipulation, the building is a wasting asset and its complete exhaustion will have been effected before the end of the lease term. The taxpayer's spreading of the wasting portion of its purchase price over the entire remaining lease term by the straight-line method approximated the minimal deduction for the taxpayer.

Furthermore, for what it may be worth, the lessor, and consequently the taxpayer, in spite of a contrary suggestion at the trial by the Commissioner's counsel, clearly owned the building in more than a bare-legal-title sense. The lease recites that all buildings erected on the premises "shall, *at and upon the construction thereof, be and become* a part of the realty and upon the termination of this lease . . . shall pass to and *remain* the property of the Lessor." (Emphasis supplied.) Consistent with this are other provisions of the lease: the reference in the tax clause to the lessor's interest in the "land or improvements"; the lessor's right to amend and even reject plans and specifications for the building; the insurance protection afforded the lessor and its being named as insured; the lessor's right to subject the improvements as well as the ground to a mortgage lien; and the lessee's inability to alter the completed building beyond a $10,000 cost without the lessor's approval. . . . This is consistent, too, with the general law, evidently recognized in Nebraska, to the effect that, unless provided otherwise by contract, a building permanently affixed to the land becomes a part of it. . . .

But the Commissioner — and the Tax Court has agreed with him — has taken the position that the taxpayer here acquired no depreciable interest in the property; that what it acquired was the land, not a wasting asset, for which it received ground rental income; that the taxpayer has not shown that it held any interest in the building for the production of income; that it acquired only such interest as its grantor Smith had; and that Smith had no depreciable interest in the lessee-constructed building. He strenuously urges, as supporting author-

and Tax Court), Friend (Tax Court) and Moore (Tax Court); see Martha R. Peters, 1945, 4 T.C. 1236, 1241-1242. It prevailed, however, in *Moore* (9 Cir.) and necessarily by the Tax Court on remand in that case. T.C. Memo. 1955-219. It was avoided in *Goelet,* on the ground the point was not preserved below or in the administrative proceedings, and in Frieda Bernstein, 1954, 22 T.C. 1146, 1151-1152, affirmed, 2 Cir., 230 F.2d 603, on the ground of failure of proof. *Moore* demonstrates, however, that one circuit has afforded relief to a taxpayer who found himself with a newly acquired interest in property with a newly acquired basis which had no rational relationship to land value alone. This alternative argument was mentioned by the Tax Court in the present case and was again rejected; it is not particularly urged by the taxpayer on this appeal.

D. The cases themselves intimate, though perhaps by indirection, that the purchase situation is distinguishable. Thus, in *Friend,* the Seventh Circuit, at p. 960 of 119 F.2d, describes the testamentary trustees' position there as though "they have the same right to amortize such cost as if the purchase had been made for cash" and, on p. 961 of 119 F.2d, denies a construction of the statute that would "place the petitioners in the position of a purchaser of the leaseholds [together with the reversions] for a valuable consideration." This latter observation was also quoted with approval by the Fourth Circuit in *Schubert,* p. 580 of 286 F.2d. In *Goelet* the district court, at p. 310 of 161 F. Supp., refers to the devisees' attempt to draw an analogy to purchase cases and says "An extension of these decisions to the instant case is not warranted. The crucial distinguishing factor is the payment of a purchase price or the existence of an investment, not present here, to which type of transaction the statute was meant to apply." When the *Friend* case, supra, was in the Board of Tax Appeals, the Board said, p. 771 of 40 B.T.A.:

> Clearly if a taxpayer had invested money in acquiring such right he would be entitled to deduct from the rents received each year an aliquot part of the cost of his investment; for he would be entitled under the same statute to recover back the cost of his investment, without being taxed thereon.

E. Finally, as a collateral comment on the cases, we cannot fail to observe that the deprecation provisions of the Internal Revenue Code draw no distinction between death-acquired property and purchased property. The basis they establish for depreciation is the same as the basis for determining gain. §167(f). The only difference is as to what that basis is. §§1011, 1012 and 1014. Once ascertained, its use, for depreciation purposes, is the same for both inherited and purchased property.

In summary, therefore, one may say of the inheritance-or-devise cases (a) that they are not without substantial criticism; (b) that many of them possess facts, particularly having to do with title and the allocation of basis to the improvement, which provide sources of difficulty and confusion; (c) that there is an alternative argument which has borne fruit in at least one circuit; (d) that the cases themselves intimate that a purchase situation may provide a different result; and (e) that the depreciation statute itself provides no basis for a distinction between the death situation and the purchase situation.

So much for these death cases. The situation before us, however, is that of a purchaser of the lessor's interest and is not that of the lessor's heir or devisee. No purchase case precisely in point has been found. We therefore start with three established propositions:

1. Where an owner of land erects a building on it and then leases it he is still entitled to recover the cost of the improvement by depreciation deductions. See . . Regs. 1.167(a)-4.

2. Where a lessee makes a capital improvement on leased property he is entitled to recover its cost by appropriate deductions for depreciation or for amortization. Regs. §§1.167(a)-4 and 1.162-11(b)(1) . . .

3. Conversely, in the situation just described, the lessor, having no investment in the lessee's improvements, is not entitled to a deduction with respect to them. 4 Mertens, §23.90, where possible exceptions to this rule are noted.

To these may be added the result reached by the death cases cited above. We think, however, that the death cases do not govern the purchase situation. We reach this result because:

A. The taxpayer-purchaser by his purchase of the property has made an investment. He is not concerned with the identity, as between his vendor-lessor and the tenant, of the builder of the building. From this point of view, if he is entitled to the deduction where his vendor-lessor was the builder, he is entitled to a deduction where the tenant was the builder.

B. To allow the purchaser to depreciate in the one situation and to deny him depreciation in the other, especially where, as here, title to the building is in the lessor and then in the purchaser, seems to be illogical, to emphasize a historical fact not participated in or caused by the purchaser and not of any other considered economic consequence to him, and to exhalt form over substance. This would be illustrated by identical buildings, one constructed by the lessor and one by the lessee, on adjoining identical lots, subject to otherwise identical leases, when both improved properties are sold to the taxpayer-purchaser. There seems to be no merit in allowing the taxpayer, as distinguished from the lessor, depreciation on the one but not on the other.

C. It is no answer to say that the lease rentals, averaging $28,500, constitute only ground rent. We are concerned here not with depreciation of rentals, but with depreciation of a portion of this taxpayer's investment in the income producing property he purchased.

D. Whatever may be the proper result in the inheritance or devise situation, as exemplified by our 1951 holding in the *Nee* case, and by the other cases cited above, we are not now willing to extend the philosophy of those cases to the purchase situation of the present litigation.

We regard Millinery Center Building Corporation v. Commissioner, 2 Cir., 1955, 221 F.2d 322, as of particular and helpful significance here. That taxpayer had leased land with an option to renew and, in accordance with the lease, had erected a substantial building on it. Title to the building was in the taxpayer but under the lease it would vest in the lessor at the end of the lease term or the lessor could then compel the taxpayer to remove it. During the lease period the taxpayer fully depreciated the cost of the building. Then it exercised its option to renew. When this was done, it bought the fee. The taxpayer sought to deduct the difference between its purchase price and the then value of the land, as unimproved, as a business expense. The Tax Court disallowed this; it also refused to accept the taxpayer's alternative contentions (a) that the difference should be amortized over the lease term and (b) that it should be depreciated over the remaining useful life of the building. 21 T.C. 817. Six judges dissented on the ground that some part of the purchase price should be allocated to the additional rights the taxpayer acquired in the building and should be recovered through depreciation. On petition for review the Second Circuit reversed on the depreciation issue. It said, p. 324 of 221 F.2d, "A third-party purchaser of such a fee would be entitled to allocate part of its cost to the building and to depreciate it as such." On the taxpayer's petition for certiorari the Supreme Court affirmed. 350 U.S. 456. The Commissioner did not seek review of the allowance of depreciation.

The taxpayer there occupied a position similar to that of the taxpayer here. The only fact differences were the taxpayer's additional posture as lessee and the lease's consequent extinguishment upon the purchase. These differences seem to us, however, of minor import.

That Farnam may have been taking depreciation with respect to its cost in the building need not concern us. Its right so to do is not here at issue. Despite the Ninth Circuit's observation, by way of dictum in the *Moore* case, p. 272 of 207 F.2d, that "A construction of the law to permit not only the lessee (who has a real economic interest) but also the taxpayer here to take depreciation on the same building would be somewhat anomalous," we fail to see the anomaly. What is significant is that each taxpayer has a separate wasting investment which meets the statutory requirements for depreciation. To allow each to recover his own, and separate, investment is not, as is suggested, to permit duplication at the expense of the revenues and is not to permit one taxpayer to depreciate another's investment. That each is concerned with the same building is of no relevance. Farnam has its lessee's cost of the structure and the present taxpayer has the portion of its purchase price attributable to the building. If two taxpayers own undivided interests in improved real estate, each may be entitled to depreciation. The situation here is not dissimilar.

This leaves only the question of proof. We could remand the case with instructions to the Tax Court to take further evidence as to that portion of the taxpayer's purchase price which was properly allocable to the building as distinguished from the land. We feel, however, that on this record the taxpayer has sufficiently established his $300,000 allocation. The Commissioner had his opportunity in the proceedings which have already taken place in the Tax Court to controvert the taxpayer's evidence. This he did not do but chose, instead, to rely on his basic thesis that the taxpayer had no investment which was entitled to depreciation.

The decision of the Tax Court is reversed with directions to recompute the taxpayer's deficiencies in accord with the views herein expressed.

NOTE

1. *What did the taxpayer purchase?* If the land was worth only $400,000 in 1950 and was likely to be worth the same amount on the expiration of the lease (as one witness testified), did the taxpayer pay $700,000 because the building was worth $300,000, or because the rental fixed in the lease was substantially more than would normally be obtainable for land worth only $400,000? If the latter hypothesis explains the taxpayer's willingness to pay $700,000, should the result in the case have been different? What would have been the proper result if the $700,000 had been paid in 1950 by two taxpayers, one of whom acquired the reversion while the other received the right to receive the rental payments due under the 1928 lease? See Rubin, Depreciation of Property Purchased Subject to a Lease, 65 Harv. L. Rev. 1134 (1952); 1220 Realty Co. v. Commissioner, 322 F.2d 495 (6th Cir. 1963).

2. *Allocation of purchase price among depreciable and non-depreciable assets.* If the taxpayer buys improved real estate for a lump sum, his cost must be allocated between the land and the improvements, since the land is not depreciable; this principle is illustrated by the *World Publishing Co.* case; see also Regs. §1.167(a)-5. Since "useful life" refers to the property's economic life rather than to its inherent physical characteristics, however, may the cost of the land be depreciated if the taxpayer can establish that it will become worthless (and will be abandoned because it will not be profitable to pay local property taxes) by reason of predictable economic changes? In Johnson v. Westover, 48 A.F.T.R. 1671 (S.D. Cal. 1955) (not officially reported), the taxpayer was allowed to depreciate part of the price paid for grazing land used for pasturage, on the ground that the

growth was not natural and would have to be renewed by replanting every ten years; but see Shainberg v. Commissioner, 33 T.C. 241, 252 (1959) (cost of shrubbery in shopping center is non-depreciable, notwithstanding estimated useful life of 10 to 15 years); Rev. Rul. 55-730, 1955-2 C.B. 53 (no depreciation for farm land composed of peat soil, notwithstanding "reliable estimate" that land will subside in 50 years and become worthless by reason of lowering of water level and other technical factors). The cost of orchards and vineyards, canals, drainage facilities, and similar improvements (as distinguished from the land itself), however, may be depreciated if a limited useful life can be established. When such improvements are made to property held for sale to customers (e.g., sewers, roads, and sidewalks installed by a dealer in subdivided residential property), depreciation is barred because the property is not used in the taxpayer's trade or business or held for the production of income within the meaning of §167(a)(1) and (2); see also Regs. §1.167(a)-2 (inventory property and stock in trade not depreciable); Cooper v. Commissioner, 31 T.C. 1155 (1959).

3. *The lessee's allowance for depreciation or amortization.* Under Regs. §1.167(a)-4 and §1.162-11(b), the lessee is allowed to recover his investment in a building erected at his expense by depreciation deductions if the useful life of the building equals or is shorter than the remaining period of the lease, and by deductions under §162 ("amortization") if the building's life exceeds the remaining period of the lease. If the allowance takes the form of depreciation, the lessee may employ the rapid methods sanctioned by §167(b); amortization, however, is confined to a series of equal annual deductions. Why?

If the lease contains an option to renew exercisable by the lessee, §178(a) provides rules for determining whether the renewal period is to be taken into account in computing the lessee's depreciation or amortization. Section 178(b) goes much further and provides that a lease (whether the lessee has an option to renew or not) shall be treated as having a life at least as long as the useful life of the building if the lessor and lessee are "related persons" (as defined). What is the reason for this provision? Section 178(c) contains a final rule to govern this area: if neither §178(a) nor §178(b) applies, the original term of the lease is controlling unless it has in fact been renewed or there is a "reasonable certainty" that it will be renewed. See Donaldson, Section 178 and Related Problems of Amortizing Leasehold Costs, 20 N.Y.U. Inst. on Fed. Taxation 537 (1962).

NACHMAN v. COMMISSIONER

191 F.2d 934 (5th Cir. 1951)

Before HUTCHESON, Chief Judge, and HOLMES and STRUM, Circuit Judges.

STRUM, Circuit Judge.

These are two consolidated petitions to review decisions of the Tax Court which modified as to amount, but otherwise sustained, deficiency assessments in income taxes entered by the Commissioner of Internal Revenue against petitioners Nachman and Tobias for their fiscal tax year 1944-45.

Desiring to enter the retail liquor business as partners in Jacksonville, Florida, petitioners on April 25, 1944, purchased from one Baker Bryan for $8,000 an existing liquor license, good until September 30, 1944, issued to Bryan by the City of Jacksonville for $750, the fee fixed by ordinance therefor. The difference between the official fee of $750 and the purchase price of $8,000 was a premium which Bryan was enabled to exact from petitioners because these licenses were restricted by law to approximately 76 for the entire City of Jacksonville, all of which were then issued. Many more persons desired them than could obtain them directly from the city, so they were in great demand, even at a premium. These licenses were assignable, and carried with them valuable renewal privileges, as it was the established practice in issuing renewal licenses from year to year to prefer the holders of existing licenses over other applicants. Because of

this known practice, and the limited number of licenses available, persons wishing to enter the liquor business in Jacksonville were willing to pay a substantial premium in order to acquire a license from an existing licensee.

In making their income tax returns for the tax year involved, petitioners deducted as an ordinary and necessary business expense, the entire $8,000 paid for the license. The Commissioner disallowed all except $\frac{5}{12}$th of the $750 annual fee, representing the unexpired portion of the license extending from April 25, 1944, the date of purchase, to September 30, 1944, when it expired. The Commissioner entered a deficiency assessment accordingly. On appeal, the Tax Court held that petitioners were entitled to deduct as ordinary business expense the entire $750 official fee, but no more, and reduced the deficiency accordingly. It is the latter determination by the Tax Court that petitioners bring here for review.

Of course it was necessary for petitioners to have a license before they could commence business. None could be procured directly from the City, as the maximum number allowed by law had already been issued. Like other scarce commodities, they commanded a premium on a seller's market. The license carried with it by established custom, if not by law, a valuable renewal privilege indispensable to petitioners' continuance in business in subsequent years. In purchasing the license, petitioners bought not only the operating right for the current year but also renewal privileges for future years. This privilege, entitling petitioners to preference over non-license holders in the issuance of renewal licenses, was of substantial value, of which the seller and the purchasers of this license were well aware. No one would pay $8,000 for a $750 license having only five months to run, unless the purchaser was reasonably sure it carried with it appurtenant privileges of substantial future value to the purchaser. It was these considerations that prompted petitioner to pay $8,000 for a $750 license, of which only $\frac{5}{12}$ths remained.

Of the $8,000 paid for the license in question, the official cost of issuance, $750, was an ordinary and necessary business expense. The remaining $7,250 was the expenditure of capital in the acquisition of a capital asset reasonably expected to serve petitioners through future years, the cost of which is not deductible as an ordinary expense. . . . The Supreme Court of Florida has recently recognized a liquor license as "property," often having an actual value far in excess of the official fee charged for it. House v. Cotton, 52 So.2d 340.

Petitioners further contend that if the $7,250 in question be regarded as the purchase price of a capital asset and therefore not deductible as ordinary business expense, they are entitled to an amortized depreciation allowance on such capital asset under [§167], and [Treasury Regs. §1.167(a)-3], relating to depreciation of intangible property. Depreciation allowance on intangibles, however, is confined to those definitely limited in duration, such as patents, franchises, copyrights, licenses for fixed periods, and the like, the partial exhaustion of which may be computed with reasonable certainty.

It is clear that the renewal privilege appurtenant to this license extends beyond, and was actually exercised beyond, the taxable year in question. Presumably the petitioners may continue to exercise their renewal privileges as long as they desire, as there is no indication that the City will depart from its custom of renewing existing licenses. How long petitioners may wish to continue exercising their renewal privileges is indeterminable. It might be for one year, or many. It was exercised by them at least as late as 1949. The basis for depreciation of an intangible capital asset is partial exhaustion due to lapse of time. This renewal privilege being of indefinite duration, dependent upon petitioners' wishes as well as upon the City's future course of action, there is no rational basis for prediction as to duration.

Moreover, if petitioners elect to discontinue the exercise of their renewal rights, it is reasonable to assume that they will sell them, just as did their predecessor Bryan, either recouping their investment or sustaining a deductible loss. We conclude therefore, as did the Tax Court, that the renewal privilege incident to the license is a nondepreciable capital asset. Clark Thread Co. v. Commissioner, 3 Cir., 100 F.2d 257.

We have examined the cases cited by the petitioners in support of their contentions, but consider them inapposite here.

Affirmed.

NOTE

1. *Goodwill as a non-depreciable asset.* The court's treatment of the cost of the license is in line with the usual treatment of expenses to acquire goodwill: the theory has been that the goodwill continues to serve the taxpayer as long as he remains in business and, if it is worthless when the business is wound up, its cost will be deductible at that time. Regs. §1.167(a)-3. See generally Note, An Inquiry into the Nature of Goodwill, 53 Colum. L. Rev. 660 (1953). Almost always, of course, the taxpayer would prefer to amortize the capitalized cost of goodwill during his successful years if he were permitted to do so, rather than wait for a large deduction in what may be a loss year. See X-Pando Corp. v. Commissioner, 7 T.C. 48 (1946); Note, 62 Yale L.J. 640 (1953). In Williams v. McGowan, 152 F.2d 570 (2d Cir. 1945), Judge L. Hand, despite the Regulations, adhered to an earlier announced view that goodwill is depreciable. Even if in theory it is depreciable, however, in practice it may be impossible to prove a limited useful life.

For other cases in which depreciation or amortization has been claimed in respect of contracts, see Thrifticheck Service Corp. v. Commissioner, 287 F.2d 1 (2d Cir. 1961) (contracts for the sale of bank checks, having a 5-year term but subject to renewal; price paid by purchaser of business for intangibles held non-depreciable for want of any reasonable estimate of useful life); Johnson v. United States, 7 A.F.T.R.2d 793 (W.D. Tex. 1961) (medical charts purchased from retiring physician held depreciable on showing of limited useful life).

In Indiana Broadcasting Corp. v. Commissioner, 41 T.C. No. 76 (1964), a broadcasting company was allowed to amortize its cost for two CBS network affiliation contracts over a 20-year period, despite the fact that such contracts had a 2-year legal life but were subject to renewal for an indefinite number of 2-year terms, upon a showing of their average life in the industry's experience; Westinghouse Broadcasting Co., Inc. v. Commissioner, 309 F.2d 279 (3d Cir. 1962), cert. denied, 372 U.S. 935 (1963), disallowing depreciation on similar contracts, was distinguished because of the limited amount of evidence there adduced.

If the number of authorized liquor licenses had been greatly increased by the municipal authorities in *Nachman*, so that the value of the taxpayer's license was substantially depressed, would he have been entitled to a deduction under §162 (business expenses) or §165 (losses)? In Reporter Publishing Co. v. Commissioner, 201 F.2d 743 (10th Cir. 1953), the taxpayer, which had paid about $80,000 for a membership in the Associated Press, deducted $30,000 as a loss when the Supreme Court, in Associated Press v. United States, 326 U.S. 1 (1945), held that a provision giving members a veto over the admission of new members in their territory was invalid. The deduction was denied, although the court conceded that the Supreme Court's decision decreased the value of the taxpayer's Associated Press membership:

> It is no doubt much less desirable since the holder thereof may no longer prevent a competitor from having such a membership. But this is a far cry from saying that it is valueless. The present membership still enables the taxpayer to receive all the services therefrom that he received before the decision by the Supreme Court. . . . If the membership had no value or utility, it would be a simple matter to surrender it and eliminate it entirely from the business. Then appellant would be entitled to the claimed deduction. But so long as the membership is being retained and used in the business, in the same way, for the same purposes and with the same beneficial results, it cannot be said to have no value. [201 F.2d at 745.]

2. *Expenditures for advertising.* So long as taxpayers are unable to depreciate goodwill, either because of the blanket disapproval of the Regulations or because of the difficulty of proving a limited life, they will be particularly eager to deduct advertising expenses, for if these expenses are capitalized, they may never be recovered out of income. Much advertising is, of course, devoted to creating goodwill; this is especially true of "institutional advertising" and of publicity for a new trade name or product. It may be noted that for excess profits tax purposes taxpayers were permitted to capitalize certain advertising expenditures (those that "may be regarded as made for the purpose of increasing the taxpayer's earning capacity over a substantial period subsequent to the taxable year in which such expenditure was made," see Regs. 130, §40.451-2(a)) in order to increase the excess profits credit. If this option was exercised, the taxpayer was required to pay the additional income tax that resulted from eliminating the deducted expenditures; see also §263(b); Regs. §1.162-14.

Except in unusual circumstances, the Internal Revenue Service appears to acquiesce in the deduction of advertising expenses, even though capitalizing them might be theoretically more appropriate. I.T. 3581, 1942-2 C.B. 88.

3. *Statutory provisions permitting the deduction or amortization of expenditures for trademarks and trade names, increasing newspaper circulation, organizing corporations, research and development, etc.* Section 177, enacted in 1956, permits certain expenditures in connection with the acquisition or protection of trademarks and trade names to be amortized over a 5-year period. In the absence of this provision, the taxpayer who wished to depreciate such expenditures would find it difficult to prove a limited useful life. See also §173, permitting the deduction of expenditures "to establish, maintain, or increase" the circulation of newspapers, magazines, and other periodicals.

The expenses of organizing a corporation, which would not be deductible because they represent a long-term investment and which would not be depreciable unless the corporation had a limited existence, may now be written off over a period of 5 years or more if the corporation elects to do so. Section 248, added by the 1954 Code. If not amortized under §248, such expenditures can presumably be deducted in the year the corporation dissolves, as formerly. See Bryant Heater Co. v. Commissioner, 231 F.2d 938 (6th Cir. 1956).

A related problem is the treatment of expenditures for research and development. Before 1954, these items were not specifically dealt with by the statute, but the government apparently allowed them to be deducted so long as that was the taxpayer's accounting practice, even when capitalization would have been the theoretically more correct practice. The courts, however, were more inclined to deny a current business deduction if the issue was raised. See Red Star Yeast & Products Co. v. Commissioner, 25 T.C. 321, 341 et seq. (1955). When research and development expenses were capitalized, the investment could be depreciated if allocable to patents or other intangibles of limited life or written off if the project was a failure, but if the investment was represented by industrial "know-how," the taxpayer would probably be unable to prove that it had a limited life. See Hart-Hartlett-Sturtevant Grain Co. v. Commissioner, 182 F.2d 153 (8th Cir. 1950).

Section 174 of the 1954 Code alters the prior law. The taxpayer is granted an option to deduct research or experimental expenditures, even if they would otherwise be chargeable to capital account. The taxpayer also has the right to amortize certain expenditures of this type over a 5-year period. The Regulations state that a taxpayer who does not elect under either §174(a) (to deduct these expenditures) or §174(b) (to defer and amortize them over a 5-year period) must capitalize his research and experimental expenditures. Regs. §1.174-1. Whether the courts will ultimately sanction this view that the enactment of §174 forecloses resort to §162(a) remains to be seen. See Alexander, Research and Experimental Expenditures Under the 1954 Code, 10 Tax L. Rev. 549 (1955); Swanson, Tax Treatment of Research and Experimentation Expenditures, 34 Taxes 541 (1956).

See also §175, allowing farmers to deduct, within specified limits, expenditures for soil and water conservation and the prevention of erosion.

4. *Depreciation of patents and copyrights.* It is usually assumed that patents and copyrights can always be depreciated over their legal lives (or over a shorter period if obsolescence is a factor). If the taxpayer buys a patent having 10 years to run with the well-

founded expectation that within that period he will have attained an impregnable position in the industry, so that the patent will have been just as useful as though its life had been unlimited, however, does the *Nachman* case justify the denial of a deduction for depreciation?

4. *Depletion*

Sections 611 and 613, relating to depletion, re-enact, with some modifications, §23(m) and §114(b) of the 1939 Code.

Although the *Baltic Mining Co.* case, supra page 70, held that an "adequate allowance . . . for the exhaustion of the ore body" resulting from mining operations is not required by the Constitution, Congress has always allowed depletion to be deducted in computing taxable income from mining and other extractive activities.

Originally, the deduction was based upon the cost of the property being depleted, and "cost depletion" is still authorized. When this method is employed, the taxpayer allocates his adjusted basis (cost, value as of March 1, 1913, or basis otherwise determined) equally among the estimated recoverable units and deducts an appropriate amount as the units are sold. Thus, if the cost to be allocated is $100,000 and there are 100,000 recoverable tons, the depletion allowance will be $1 per ton, deducted as the ore is sold. The provision considered in the *Baltic Mining Co.* case, providing that the depletion allowance might not in any circumstances exceed 5 per cent of gross income, was repealed in 1916.

Until 1954, a second authorized method of computing depletion was to use "discovery value" as the amount to be recovered tax-free by the taxpayer. This method, first granted as an incentive to exploration in 1918, permitted the taxpayer to take the fair market value of the mine at the time of discovery or within 30 days thereafter and to allocate this amount (no matter how much it exceeded his cost) among the recoverable units to find the depletion allowance per unit. See Holloway v. Commissioner, 21 T.C. 40 (1953). Although popular at one time, this method was seldom encountered in recent years, because it was not allowed for deposits entitled to percentage depletion, and these constituted an ever-widening group. The 1954 Code made percentage depletion generally available, and discovery value depletion is no longer authorized.

The percentage depletion method ignores both the taxpayer's cost and the number of recoverable units. Instead, the taxpayer is permitted to deduct a given percentage of his gross income (but not to exceed 50 per cent of taxable income calculated before depletion is taken) as a depletion allowance. This method avoids the problem, common to both cost and discovery value depletion, of estimating the number of recoverable units in the deposit in question, an estimate that may be only the wildest of guesses.* For the taxpayer, percentage depletion has the special attraction of increasing the depletion allowance when income rises, which ordinarily is when the deduction will save most in taxes. Even more important, percentage depletion just keeps rolling along, even after the taxpayer's full cost or discovery value has been recovered. This feature is not an essential of percentage depletion, since the taxpayer *could* be restricted in his total lifetime recoveries to the cost or discovery value of the deposit, but the statute does not now contain such a limitation. Percentage depletion is of particular importance in the petroleum industry ($27\frac{1}{2}$ per cent being the figure applicable to oil and gas), but it is now granted, at various rates, to a wide variety of deposits listed in

* Despite this, the taxpayer may have to compute depletion on a cost basis for some purposes (most notably, in calculating a corporation's "earnings and profits," infra p. 646) even though percentage depletion is used in determining taxable income.

§163(b) and, lest any be omitted, to all other minerals, excluding only "soil, sod, dirt, turf, water, or mosses" and "minerals from sea water, the air, or similar inexhaustible sources."

COMMISSIONER v. SOUTHWEST EXPLORATION CO.

350 U.S. 308 (1956)

MR. JUSTICE CLARK delivered the opinion of the Court.

The Southwest Exploration Co., respondent in No. 286, contracted to develop certain oil deposits lying off the coast of California by whipstock drilling from sites located on the property of adjacent upland owners. Southwest agreed to pay to such owners 24½% of the net profits for the use of their land. Both Southwest and the upland owners sought to take the statutory depletion allowance of 27½% on this share of the profits. The Tax Court decided that Southwest was entitled to the depletion allowance, and the Ninth Circuit affirmed. In the other case, the Court of Claims held that one of the upland owners, Huntington Beach Co., respondent in No. 287, was entitled to the depletion allowance on its share of the net income. We granted certiorari in both cases because both the drilling company and the upland owners cannot be entitled to depletion on the same income. We agree with the Court of Claims.[1]

The California State Lands Act of 1938 provided that the State's offshore oil might be extracted only from wells drilled on filled lands or slant drilled from upland drill sites to the submerged oil deposits. Other provisions of the same statute required that "derricks, machinery, and any and all other surface structures, equipment, and appliances" be located only on filled lands or uplands. It was further provided that the state commission might require each prospective bidder for such a state lease to furnish, as a condition precedent to consideration of his bid, satisfactory evidence of "present ability to furnish all necessary sites and rights of way for all operations contemplated under the provisions of the proposed lease."

In 1938 California published notice of its intention to receive bids for the lease of certain oil lands pursuant to this statute. At the time Southwest — a corporation organized in 1933 but completely inactive until the transaction at issue here — did not own, lease, operate or control any of the uplands adjacent to the area of oil deposits. It is agreed that there were no filled lands available. Southwest entered into three agreements with the upland owners, and was granted the right of ingress to and egress from the designated uplands and the right to construct, use and maintain all equipment necessary for drilling on the same lands. The upland owners reserved to themselves the right to give easements or subsurface well crossings in the uplands, except that they would not allow such easements for the purpose of drilling into the offshore oil deposits while Southwest retained an interest granted to it by state easement. Southwest's rights were expressly subject to all rights previously granted by the upland owners. The agreements defined "net profits" and provided that Southwest would pay a total of 24½% of its net profits from extraction and sale of oil to the upland owners. It was also provided that the upland owners did not acquire a share in the lease or oil deposit by virtue of the last agreement and that it was not the intention of the parties to create a partnership relationship.

As a result of these agreements, the upland owners endorsed Southwest's bid

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[1] In the courts below, the Commissioner took technically inconsistent positions, opposing the depletion allowance in both cases and losing in both. Before this Court the Commissioner urged that depletion be denied the drilling company and allowed to the upland owners on the latter's 24½% of net profits.

for a lease submitted to the State of California. Southwest, as the only bidder, was granted "Easement No. 392" by the State in consideration of the "royalty to be paid, the covenants to be performed, and the conditions to be observed by the Grantee." One such condition was that set out in paragraph (1):

> That each well drilled pursuant to the terms of this agreement shall be slant drilled from the uplands to and into the subsurface of the State lands. Derricks, machinery, and any and all other surface structures, equipment and appliances shall be located only upon the uplands and all surface operations shall be conducted therefrom.

The agreement further provided that, if Southwest should "default in the performance or observance of any of the terms, covenants and stipulations hereof," the State might re-enter, cancel the agreement or close down wells not being operated according to the agreement.

The wells drilled pursuant to this lease have produced oil continuously since 1939. In No. 286, Southwest Exploration Co., the tax years 1939 through 1945 are involved. If Southwest may claim the depletion allowance on the upland owner's share of the profits during this period, its tax liability is reduced by approximately $175,000. In No. 287, Huntington Beach Co., the upland owner is claiming a tax refund of $135,000 for the year 1948 alone.

An allowance for depletion has been recognized in our revenue laws since 1913. It is based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit. Presently, the depletion allowance is a fixed percentage of gross income which Congress allows to be excluded; this exclusion is designed to permit a recoupment of the owner's capital investment in the minerals so that when the minerals are exhausted, the owner's capital is unimpaired. The present allowance, however, bears little relationship to the capital investment, and the taxpayer is not limited to a recoupment of his original investment. The allowance continues so long as minerals are extracted, and even though no money was actually invested in the deposit. The depletion allowance . . . is solely a matter of congressional grace; it is limited to 27½% of gross income from the property after excluding from gross income "any rents or royalties" paid by the taxpayer with respect to the property [§611(a), §613(a), and §613(b)(1)].

In determining which parties are entitled to depletion on oil and gas income, this Court has relied on two interrelated concepts which were first formulated in Palmer v. Bender, 287 U.S. 551. There, the taxpayer, a lessee of certain oil and gas properties, had transferred his interest in these properties to two oil companies in return for a cash bonus, a future payment to be made "out of one-half of the first oil produced and saved," and an additional royalty of one-eighth of the oil produced and saved. In upholding the taxpayer's right to depletion on all such income, the Court based its decision on the grounds that a taxpayer is entitled to depletion where he has: (1) "acquired, by investment, any interest in the oil in place," and (2) secured by legal relationship "income derived from the extraction of the oil, to which he must look for a return of his capital." 287 U.S., at 557.

These two factors, usually considered together, constitute the requirement of "an economic interest." This Court has found the requisite interest in the oil in place to have been retained by the assignor of an oil lease, Thomas v. Perkins, 301 U.S. 655, the lessor of oil properties for a share of net profits, Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, and the grantor of oil lands considered as an assignor of drilling rights, Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25. The Court found no such interest in the case of a processor of natural gas who had only contracted to buy gas after extraction, Helvering v. Bankline Oil Co.,

303 U.S. 362, and in the case of a former stockholder who had traded his shares in a corporation which owned oil leases for a share of net income from production of the leased wells, Helvering v. O'Donnell, 303 U.S. 370.

The second factor has been interpreted to mean that the taxpayer must look *solely* to the extraction of oil or gas for a return of his capital, and depletion has been denied where the payments were not dependent on production, Helvering v. Elbe Oil Land Co., 303 U.S. 372, or where payments might have been made from a sale of any part of the fee interest as well as from production. Anderson v. Helvering, 310 U.S. 404. It is not seriously disputed here that this requirement has been met. The problem revolves around the requirement of an interest in the oil in place.

It is to be noted that in each of the prior cases where the taxpayer has had a sufficient economic interest to entitle him to depletion, he has once had at least a fee or leasehold in the oil-producing properties themselves. No prior depletion case decided by this Court has presented a situation analogous to that here, where a fee owner of adjoining lands necessary to the extraction of oil is claiming a depletion allowance.

Southwest contends that there can be no economic interest separate from the right to enter and drill for oil on the land itself. Since the upland owners did not themselves have the right to drill for offshore oil, it is argued that respondent — who has the sole right to drill — has the sole economic interest. It is true that the exclusive right to drill was granted to Southwest, and it is also true that the agreements expressly create no interest in the oil in the upland owners. But the tax law deals in economic realities, not legal abstractions, and upon closer analysis it becomes clear that these factors do not preclude an economic interest in the upland owners.

Southwest's right to drill was clearly a conditional rather than an absolute grant. Without the prior agreements with the upland owners, Southwest could not even have qualified as a bidder for a state lease. Permission to use the upland sites was the express condition precedent to the State's consideration of Southwest's bid, and it was one of the express conditions on which "Easement No. 392" was granted to Southwest. For a default in that condition the State retained the right to re-enter or to cancel the lease. Thus it is seen that the upland owners have played a vital role at each successive stage of the proceedings. Without their participation there could have been no bid, no lease, no wells and no production.

But Southwest contends that the upland owners here contributed merely property which was useful but not necessary to the drilling operation. The facts are to the contrary. State law required that the wells be drilled either on the uplands or on filled lands, and there were no filled lands available. By hindsight Southwest now suggests that it might have constructed a drilling island which might have been considered as filled land under the statute. Then, too, perhaps the State itself might have changed the law or condemned the uplands under existing law. But none of these possibilities occurred. The fact is that the drilling arrangement was achieved and oil produced in the only way that it could have been, consistent with state law and the express requirements of the State's lease.

Recognizing that the law of depletion requires an economic rather than a legal interest in the oil in place, we may proceed to the question of whether the upland owners had such an economic interest here. We find that they did. Proximity to the offshore oil deposits and effect of the state law combined to make the upland owners essential parties to any drilling operations. This controlling position greatly enhanced the value of their land when extraction of oil from the State's offshore fields became a possibility. The owners might have realized this value by selling their interest for a stated sum and no problem of depletion would have

been presented. But instead they chose to contribute the use of their land in return for rental based on a share of net profits. This contribution was an investment in the oil in place sufficient to establish their economic interest. Their income was dependent entirely on production, and the value of their interest decreased with each barrel of oil produced. No more is required by any of the earlier cases.

Southwest contends, finally, that if depletion is allowed to the upland owners in this case, it would be difficult to limit the principle in instances of strangers "disassociated from the lease" who may have contributed an essential facility to the drilling operation in return for a share of the net profits. But those problems are not before us in this case where the upland owners could hardly be said to be "disassociated from the lease." We decide only that where, in the circumstances of this case, a party essential to the drilling for and extraction of oil has made an indispensable contribution of the use of real property adjacent to the oil deposits in return for a share in the net profits from the production of oil, that party has an economic interest which entitles him to depletion on the income thus received.

For the foregoing reasons the judgment in No. 286, as to Southwest Exploration Company, is reversed and that in No. 287, as to Huntington Beach Company, is affirmed.

No. 286, Reversed.

No. 287, Affirmed.

MR. JUSTICE DOUGLAS dissents.

MR. JUSTICE HARLAN took no part in the consideration or decision of these cases.

UNITED STATES v. CANNELTON SEWER PIPE CO.

364 U.S. 76 (1960)

MR. JUSTICE CLARK delivered the opinion of the Court.

This income tax refund suit involves the statutory percentage depletion allowance to which respondent, an integrated miner-manufacturer of burnt clay products from fire clay and shale, is entitled under the Internal Revenue Code of 1939.*

The percentage granted by the statute is on respondent's "gross income from mining." It defines "mining" to include the "ordinary treatment processes normally applied by mine owners . . . to obtain the commercially marketable mineral product or products." Respondent claimed that its first "commercially marketable mineral product" is sewer pipe and other vitrified articles. Alternatively, it contended that depletion should be based on the price of 80 tons of ground fire clay and shale actually sold during the tax year in question. The District Court agreed with respondent's first claim. The Court of Appeals affirmed, holding that respondent could not profitably sell its raw fire clay and shale without processing it into finished products, and that its statutory percentage depletion was therefore properly based on its gross sales of the latter. 268 F.2d 334. The Government contends that the product from which "gross income from mining" is computed is an industry-wide test and cannot be reduced to a particular operation that a taxpayer might find profitable. The Government further argues that, while the statute permits ordinary treatment processes normally applied by miners to the raw product of their mines to produce a commercially marketable mineral product, it does not embrace the fabrication of the mineral product into finished articles. In view of the importance of the question to tax-

* For present law, see Editor's Note following the decision. — ED.

payers as well as to the Government, we granted certiorari. 361 U.S. 923. We disagree with respondent's contention that the issue is not presented by this record, and we therefore reach the merits. We have concluded that, under the mandate of the statute, respondent's "gross income from mining" under the findings here is the value of its raw fire clay and shale, after the application of the ordinary treatment processes normally applied by nonintegrated miners engaged in the recovery of those minerals.[1]

I

During the tax year ending November 30, 1951, the respondent owned and operated an underground mine from which it produced fire clay and shale in proportions of 60% fire clay and 40% shale. It transported the raw mineral product by truck to its plant at Cannelton, Indiana, about one and one-half miles distant. There it processed and fabricated the fire clay and shale into vitrified sewer pipe, flue lining and related products. In this process, the clay and shale is first ground into a pulverized form about as fine as talcum powder. The powder is then mixed with water in a pug mill and becomes a plastic mass, which is formed by machines into the shape of the finished ware desired. The ware is then placed in dryers where heat of less than 212° is applied to remove all of the water. This process takes from 12 hours to 3 weeks, depending on the size of the ware. Thereafter the ware is vitrified in kilns at 2,200° Fahrenheit, requiring from 60 to 210 hours. It is then cooled, graded and either shipped or stored.

Not all clays and shales are suitable for respondent's operations. They must have plasticity, special drying qualities and be able to withstand high temperatures. Respondent's clay, known as Cannelton clay, is the deepest clay mined in Indiana and, respondent says, yields the best sewer pipe. Its cost of removing and delivering the same to its plant was $2.418 per ton in 1951. Respondent used some 38,473 tons of clay and shale in its operations that year and sold approximately 80 tons of ground fire clay and shale in bags at a price of $22.88 per ton. Net sales of its finished wares amounted to approximately one and a half million dollars.

In connection with its tax assessment for the year in question, respondent filed a document in which it stated that "we used as a basis for calculating the gross income from our mining operations of shale and fire clay the point in our manufacturing operations at which we first arrive with a commercially marketable product, which is ground fire clay. This product arrives after the raw mineral is crushed and granulated to such extent that by the addition of water it can be made into a mortar for use in laying or setting fire or refractory brick. This ground fire clay has a definite market and an ascertainable market value at any particular time and is the same product from which our end product, sewer tile, is made simply by the addition of water and the necessary baking process." In this return it based the value of the ground fire clay at $22.81 per ton, the price for which it sold some 80 tons of that material in bags during 1951. At this figure the depletion allowance would have been slightly above $2 per ton. Thereafter respondent claimed error and asserted that its mineral product, rather than being commercially marketable when it reached the stage of ground fire clay, only became commercially marketable when it became a finished product, e.g., sewer pipe. On this basis, the depletion allowance on petitioner's gross income would be approximately $4 per ton, since the mineral would have a value of about $40

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1 The quantity of ground and bagged fire clay and shale actually sold is too negligible to furnish an appropriate basis for computing depletion.

per ton. On the other hand, if the mineral it used in 1951 was valued at $1.60 to $1.90 per ton, the going price elsewhere in Indiana, the depletion allowance would be approximately 20¢ per ton.

The record shows and the District Court found that in 1951 there were substantial sales of raw fire clay and shale in Indiana, mostly in the vicinity of Brazil, about 140 miles from Cannelton. The average price there was $1.60 to $1.90 per ton for fire clay and $1 per ton for shale. Transportation costs from Brazil to Cannelton ran from $4.58 to $5.50 per ton. In Kentucky, across the river from respondent's plant, it appears that fire clay and shale of the same grade were mined and sold before, during and subsequent to 1951. In fact, since 1957 respondent has secured all of its mineral requirements from this source on a lease basis under which the lessor mines and delivers the raw material to its plant. The exact cost is not shown, but the haul in 1957 from pit to plant, including the ferry crossing, was some seven miles.

II

We have carefully studied the legislative history of the depletion allowance, including the voluminous materials furnished by the parties, not only in their briefs but in the exhaustive [685-page] appendices and the record. We shall not burden this opinion with its repetition.

In summary, mineral depletion for tax purposes is an allowance from income for the exhaustion of capital assets. Anderson v. Helvering, 310 U.S. 404 (1940). In addition, it is based on the belief that its allowance encourages extensive exploration and increasing discoveries of additional minerals to the benefit of the economy and strength of the Nation. We are not concerned with the validity of this theory or with the statutory policy. Our sole function is application of the congressional mandate. A study of the materials indicates that percentage depletion first came into the tax structure in 1926, when the Congress granted it to oil and gas producers. The percentage allowed was based on "gross income from the property," which was described as "the gross receipts from the sale of oil and gas as it is delivered from the property." Preliminary Report, Joint Committee on Internal Revenue Taxation, Vol. I, Part 2 (1927). The report continued that, as to the integrated operator, "the gross income from the property must be computed from the production and posted price of oil, as the gross receipts from a refined and transported product can not be used in determining the income as relating to an individual tract or lease." The Treasury Regulations confirmed this understanding. Treas. Reg. 74 (1929 ed.), Arts. 221(i), 241.

Thereafter, in 1932, percentage depletion was extended to metal mines, coal, and sulphur. The mining engineer of the Joint Committee, Alex. R. Shepherd, urged in a report to the Congress that depletion for metal mines be computed, as in the oil and gas industry, on a percentage-of-income basis, and the Revenue Act of 1932 was so drawn. The Shepherd Report pointed out that the percentage basis for oil and gas depletion had been in force for over a year and had "functioned satisfactorily both from economical and administrative viewpoints and without loss of revenue." It added that "careful study of this method as applied to metal mines indicates that the same results will be attained in practice as in the case of oil and gas," but that, because of varied practices in the mining industry, it would be necessary to determine "the point in accounting at which" gross income from the property mined could be calculated. It recommended that "it is logical to peg 'gross income from the property' f.o.b. cars at mine," i.e., net smelter returns, recognizing that processing beyond this point should not be included in calculating "gross income from the property." While as to certain metals, viz.,

gold, silver, or copper, the report suggested that gross income should be based on receipts from "the sale of the crude, partially beneficiated or refined" product, this was but to make provision for the specific operations of miners in those metals. In this regard the report also proposed that the depletion base "in the case of all other metals, coal and oil and gas, [should be] the competitive market receipts, or its equivalent, received from the sale of the crude products, or concentrates on an f.o.b. mine, mill, or well basis."

The Congress in fashioning the 1932 Act took into account these recommendations. It incorporated a provision in the Act allowing percentage depletion for coal and metal mines and sulphur, based on the "gross income from the property." §114(b)(4), Revenue Act of 1932, 47 Stat. 169. On the following February 10, 1933, the Treasury issued its Regulations 77, which defined "gross income from the property" as "the amount for which the taxpayer sells (a) the crude mineral product of the property or (b) the product derived therefrom, not to exceed in the case of (a) the representative market or field price . . . or in the case of (b) the representative market or field price . . . of a product of the kind and grade from which the product sold was derived, before the application of any processes . . . with the exception of those listed. . . ." Treas. Reg. 77, Art. 221(g). These exceptions listed processes normally in use in the mining industry for preparing the mineral as a marketable shipping product. The regulation was of unquestioned validity and, in 1943, at the instance of the industry, the Congress substantially embodied it into the statute itself, 58 Stat. 21, 44, including the basic definition of the term "gross income from the property." Since that time the section on percentage depletion — §114(b)(4)(B) of the 1939 Code — has remained basically the same. Additional minerals have been added from time to time — shale and fire clay in 1951 — until practically all minerals are included.

As now enacted, the section provides that "mining" includes "not merely the extraction of the ores or minerals from the ground but also the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable mineral product or products," plus transportation from the place of extraction to the "plants or mills in which the ordinary treatment processes are applied thereto," not exceeding 50 miles. It then defines "ordinary treatment processes" by setting out specifically in four categories those covering some 17 named minerals. Fire clay and shale are not within these specific enumerations. The Government, however, contends that they should come within clause (iii) of the section, which provides that, "in the case of iron ore, bauxite, ball and sagger clay, rock asphalt, *and minerals which are customarily sold in the form of a crude mineral product* — sorting, concentrating, and sintering to bring to shipping grade and form, and loading for shipment . . ." are included in "ordinary treatment processes." (Italics added.) Clause (iv) lists specific metals such as lead, zinc, copper, etc., "and ores which are not customarily sold in the form of crude mineral product," and specifically excludes from the permissible processes certain ones used in connection with these metals. To recapitulate, the section contains four categories of "ordinary treatment processes": the first enumerating those permissible as to the mining of coal; the second, as to sulphur; the third, as to minerals customarily sold in the form of the crude mineral product; and the fourth, as to those ores not customarily so sold. We note that the Congress even states the steps in each permissible process, and in addition specifically declares some processes not to be "ordinary treatment" ones, viz., "electrolytic deposition, roasting, thermal or electric smelting, or refining." Furthermore, none of the permissible processes destroy the physical or chemical identity of the minerals or permit them to be transformed into new products.

From this legislative history, we conclude that Congress intended to grant miners

a depletion allowance based on the constructive income from the raw mineral product, if marketable in that form, and not on the value of the finished articles.

III

The findings are that three-fifths of the fire clay produced in Indiana in 1951 was sold in its raw state. This indicates a substantial market for the raw mineral. In addition, large sales of raw fire clay and shale were made across the river in Kentucky. This indicates that fire clay and shale were "commercially marketable" in their raw state unless that phrase also implies marketability at a profit. We believe it does not. Proof of these sales is significant not because it reveals an ability to sell profitably — which the respondent could not do — but because the substantial tonnage being sold in a raw state provides conclusive proof that, when extracted from the mine, the fire clay and shale are in such a state that they are ready for industrial use or consumption — in short, they have passed the "mining" state on which the depletion principle operates. It would be strange, indeed, to ascribe to the Congress an intent to permit each miner to adopt processes peculiar to his individual operation. Depletion, as we have said, is an allowance for the exhaustion of capital assets. It is not a subsidy to manufacturers or the high-cost mine operator. The value of respondent's vitrified clay products, obtained by expensive manufacturing processes, bears little relation to the value of its minerals. The question in depletion is what allowance is necessary to permit tax-free recovery of the capital value of the minerals.

Respondent insists that its miner-manufacturer status makes some difference. We think not. It is true that the integrated miners in Indiana outnumbered the nonintegrated ones. But in each of the three basic percentage depletion Acts the Congress indicated that integrated operators should not receive preferred treatment. Furthermore, in Regulations 77, discussed above, the Treasury specifically provided that depletion was allowable only on the crude mineral product. And, as we have said, this regulation was substantially enacted into the 1943 Act. We need not tarry to deal with any differences which are said to have existed in administrative interpretation, for here we have authoritative congressional action itself. Ever since the first percentage depletion statute, the cut-off point where "gross income from mining" stopped has been the same, i.e., where the ordinary miner shipped the product of his mine. Respondent's formula would not only give it a preference over the ordinary nonintegrated miner, but also would grant it a decided competitive advantage over its nonintegrated manufacturer competitor. Congress never intended that depletion create such a discriminatory situation. As we see it, the miner-manufacturer is but selling to himself the crude mineral that he mines, insofar as the depletion allowance is concerned.

IV

We now reach what "ordinary treatment processes" are available to respondent under the statute. As the principal industry witness put it at hearings before the Congress: "Obviously it was not the intent of Congress that those processes which would take your products and make them into different products having very different uses should be considered, as the basis of depletion." But respondent says that the processes it uses are the ordinary ones applied in the industry. As to the miner-manufacturer, that is true. But they are not the "ordinary" normal ones applied by the nonintegrated miner. It was he whom the Congress made the object of the allowance. The fabrication processes used by respondent in manufacturing sewer pipe would not be employed by the run-of-the-mill miner —

only an integrated miner-manufacturer would have occasion to use them.

Respondent further contends, however, that it must utilize these processes in order to obtain a "commercially marketable mineral product or products." It points out that its underground method of mining prevents it from selling its raw fire clay and shale. This position leads to the conclusion that respondent's mineral product has no value to it in the ground. If this be true, then there could be no depletion. One cannot deplete nothing. On the other hand, respondent alleges that its minerals yield "the best sewer pipe which is made in Indiana." If this be true, then respondent's problem is one purely of cost of recovery, an item which, as we have said, has nothing to do with value in the depletion formulae. Depletion, as we read the legislative history, was designed not to recompense for costs of recovery but for exhaustion of mineral assets alone. If it were extended as respondent asks, the miner-manufacturer would enjoy, in addition to a depletion allowance on his minerals, a similar allowance on his manufacturing costs, including depreciation on his manufacturing plant, machinery and facilities. Nor do we read the use by the Congress of the plural word "products" in the "commercially marketable" phrase as indicating that normal processing techniques might include the fabrication of different products from the same mineral. We believe that the Congress was only recognizing that in mining operations often more than one mineral product was recovered in its raw state.

In view of the finding that substantial quantities — in fact, the majority — of the tonnage production of fire clay and shale were sold in their raw state, we believe that respondent's mining activity during the year in question would come under clause (iii) of the section here involved. That clause includes "minerals which are customarily sold in the form of a crude mineral product." We believe that the Congress intended integrated mining-manufacturing operations to be treated as if the operator were selling the mineral mined to himself for fabrication. It would, of course, be permissible for such an operator to calculate his "gross income from mining" at the point where "ordinary" miners — not integrated — disposed of their product. All processes used by the nonintegrated miner before shipping the raw fire clay and shale would under such a formula be available to the integrated miner-manufacturer to the same extent but no more.

Nor do we believe that the District Court and the Court of Appeals cases involving percentage depletion and cited by respondent are apposite here.[2] We do not, however, indicate any approval of their holdings. It is sufficient to say that on their facts they are all distinguishable.

In view of these considerations, neither of respondent's alternate claims for depletion allowance is appropriate. The judgment of the Court of Appeals is therefore reversed, and the cause remanded for further proceedings in conformity with this opinion.

It is so ordered.

MR. JUSTICE HARLAN, concurring in the result.

[Mr. Justice Harlan concurred in the result on the ground that the 1933 Regula-

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2 Respondent's cases are based on United States v. Cherokee Brick & Tile Co., 218 F.2d 424 (adhered to in United States v. Merry Bros. Brick & Tile Co., 242 F.2d 708), which went off on factual concessions not present here. They have been pyramided into a statistically imposing number of cases, predicated upon one another. Close analysis indicates that they either go off on concessions or findings not present here, or deal with controversies over particular treatment processes claimed as "ordinary" in the industry involved. For our purposes, we need not reach the question of whether in those cases the minerals in place had any "value" to be depleted. Other than the decision here under review, only two of the Court of Appeals cases cited by respondent, both from the same Circuit (Commissioner v. Iowa Limestone Co., 269 F.2d 398; Bookwalter v. Centropolis Crusher Co., 272 F.2d 391), adopt the profitability test, which we find unacceptable.

tion was a valid exercise of administrative authority and through history had become an authoritative gloss on the statute.]

NOTE

1. *The concept of an "economic interest" in the depletable mineral.* As the *Southwest Exploration Co.* case indicates, there are many problems in determining which of the many persons with a financial stake in the extraction of a mineral are entitled to a deduction for depletion. For a review of the issues and cases, see Sneed, The Economic Interest — An Expanding Concept, 35 Texas L. Rev. 307 (1957).

2. *"Gross income from mining."* The *Cannelton* case illustrates the difficulty of measuring, in the case of an integrated business, the taxpayer's "gross income from mining," which (except in the case of oil and gas) is the base to which the appropriate depletion rate is applied in computing the amount to be deducted. The range of choice in *Cannelton* was from $1.60 to $40 per ton, but for some other minerals the range is even more dramatic: salt, for example, is worth $10 per ton at an early point in the extractive process, but its value is $1800 per ton after it has been purified for table use and packed in small containers for sale to consumers. For discussion, see White and Brainerd, Percentage Depletion of Minerals — A Costly Study in Definitions, 34 Taxes 97 (1956).

For the years before the Court in the *Cannelton* case, "mining," as used in the term "gross income from mining," was defined to include "the ordinary treatment processes normally applied by mine owners or operators in order to obtain the commercially marketable product or product" (plus certain transportation), and the term "ordinary treatment processes" was in turn defined to include certain specified technical processes, to include such others as might be prescribed by the Treasury, and to exclude still others. A few days before the *Cannelton* case was decided, a House-Senate conference committee recommended a statutory change, which became law just three days after the decision: the statutory reference to "ordinary treatment processes normally applied . . . in order to obtain the commercially marketable product or products" was repealed, and §613(c) was given its present form, under which "mining" includes the technical processes that were previously specified (with a few additions) plus those that are specified by Treasury Regulations, and excludes certain others. See generally Taubeneck, The Depletion Base Controversy, 46 A.B.A.J. 1136 (1960). The result in the *Cannelton* case itself was altered prospectively by the 1960 legislation, since §613(c)(4)(G) now contains an explicit statement of the processes that qualify in the case of clay used for sewer pipe, and in 1961 Congress rejected the *Cannelton* holding retroactively on the ground that it departed from earlier case law on which taxpayers in the clay and shale industry had properly relied. The majority and minority Congressional views, together with a statement of the Treasury's position, are reprinted in 1961-2 C.B. 429 et seq.

3. *Option to deduct expenditures for mineral exploration and development.* In 1951, some of the extractive industries gained the unusual option of capitalizing or "expensing," as the taxpayer chooses, certain costs of exploration and development that would otherwise have to be capitalized. §§615 and 616. Ordinarily, of course, a taxpayer who writes off items to expense simply accelerates a tax benefit that he would otherwise obtain (if he capitalized them) through increased depreciation or depletion or an increased basis for calculating gain or loss on sale. But for the taxpayer who is entitled to use percentage depletion, which is not restricted to the basis of the property, the right to "expense" an item is unusually advantageous. See Alexander and Grant, Mine Development and Exploration Expenditures, 8 Tax L. Rev. 401 (1953).

The 1951 amendments did not include the oil and gas industry. But for some years, the Regulations had permitted the oil and gas taxpayer either to expense or to capitalize intangible drilling and development costs. Regs. 118, §39.23(m)-16. Drilling and development costs that are reflected in tangible equipment are not included in this option; they must be capitalized and recovered by depreciation deductions. But the *intangible* costs would ordinarily be attributed to the cost of the oil and gas and thus be recovered through the depletion allowance. Since percentage depletion is not limited by the deposit's cost, the taxpayer will usually prefer to "expense" his intangible costs. Con-

sternation was created in the industry in 1945 when the Court of Appeals for the Fifth Circuit, in F.H.E. Oil Co. v. Commissioner, 147 F.2d 1002 (5th Cir. 1945), held that the Regulations were invalid in permitting the taxpayer to deduct a capital expenditure. The opinion was somewhat modified on rehearing, after briefs had been filed by thirty counsel for other oil producers, appearing amici curiae, alleging that a billion dollars of deductions were imperiled by the opinion. F.H.E. Oil Co. v. Commissioner, 149 F.2d 238 (5th Cir. 1945). A few weeks later Congress passed a concurrent resolution declaring that it had approved the questioned Regulations by re-enacting §23 of the 1939 Code with knowledge of the Treasury's interpretation of it. 59 Stat. (Part 2) 844 (1945). What is the effect of such a resolution? F.H.E. Oil Co. v. Commissioner, 150 F.2d 857 (5th Cir. 1945); Gibson, Congressional Concurrent Resolutions: An Aid to Statutory Interpretation? 37 A.B.A.J. 421 (1951). Whatever the effect of the concurrent resolution of 1945, the enactment of §263(c) of the 1954 Code put the Congressional stamp of approval on the Regulations for future years.

4. *References.* The hotly debated issues of policy in percentage depletion are acutely summarized by Dean Griswold and Rex G. Baker in their Percentage Depletion — A Correspondence, 64 Harv. L. Rev. 361 (1951); see also Galvin, The "Ought" and "Is" of Oil-and-Gas Taxation, 73 Harv. L. Rev. 1441 (1960); Eldridge, Tax Incentives for Mineral Enterprise, 58 J. Pol. Econ. 222 (1950); Galvin, Federal Income Tax — Percentage Depletion of Oil and Gas Wells, 21 Texas L. Rev. 410 (1943); Jackson, Federal Income Tax Percentage Depletion of Oil and Gas Wells — Another View, id. 798 (1947); Freeman, Percentage Depletion for Oil — A Policy Issue, 30 Ind. L.J. 399 (1955). For the views of a number of authorities, see the articles in 2 Tax Revision Compendium 933-1059 (House Ways and Means Committee, 1959), and in Federal Tax Policy for Economic Growth and Stability 419-493 (Joint Committee on the Economic Report, 1956).

For a proposal to make everyone rich, see Blum, How to Get All (But All) the Tax Advantages of Dabbling in Oil, 31 Taxes 343 (1953).

5. *The Optional Standard Deduction*

Sections 141-144, relating to the optional standard deduction, are based on §23(aa) of the 1939 Code, but the "minimum standard deduction" of §141(c) was enacted in 1964.

Section 62, defining "adjusted gross income," re-enacts, with a few substantive changes, §22(n) of the 1939 Code. See also §36 (loss of certain credits if standard deduction is elected), which corresponds to §23(aa)(2) of the 1939 Code.

Although the optional standard deduction, if elected by the taxpayer, displaces all personal deductions (supra p. 163), it displaces only a few of the deductions considered in this chapter:

1. *Trade or business expenses.* These expenses are ordinarily allowed in addition to the optional standard deduction, except that if they are incurred by the taxpayer "in connection with the performance by him of services as an employee," they are allowed only if they consist of (a) expenses paid by him under a reimbursement or other expense allowance arrangement with his employer, (b) expenses of travel, meals, and lodging while away from home, (c) expenses of transportation, or (d) trade or business expenses of an "outside salesman." See §62(2).

A surprising volume of litigation, considering the small amounts ordinarily involved, has been required as a result of this treatment of the employee. In the first place, when is a taxpayer an independent contractor, not an employee, so as to be entitled to deduct all trade and business expenses in addition to the standard deduction? Kershner v. Commissioner, 14 T.C. 168 (1950); Meisinger v. Commissioner, ¶52,178 P-H Memo T.C.

Secondly, what is a "reimbursement or other expense allowance arrangement"? McKinney v. Commissioner, ¶48,265 P-H Memo T.C. Apparently an employee

can get the benefit of all of his trade or business expenses, as well as the optional standard deduction, if his employer reimburses his expenses separately from the salary, instead of paying a larger salary and expecting the employee to pay the expenses himself.

The 1954 Code liberalized this area somewhat by allowing items (c) and (d) above to be deducted; previously, only items (a) and (b) were allowable. Item (c) takes care of automobile expenses incurred by employees who return home every night; and item (d) allows "outside salesmen," as defined by §62(2)(D), to deduct telephone and telegraph, secretarial, and entertainment expenses in addition to the standard deduction.

The "moving expense" deduction of §217 (supra page 227) is also allowed even though the taxpayer elects to use the standard deduction.

2. *Expenses of profit-seeking transactions.* By electing the optional standard deduction, the taxpayer forfeits certain of the deductions otherwise available under §§212 and 165. Deductions attributable to property held for the production of rents and royalties are still allowable. But expenses attributable to other property held for income (e.g., securities) are not allowed, nor are losses on transactions entered into for profit if there is no sale or exchange of property.

Certain credits are also denied if the standard deduction is taken. §36.

Upon what theory — or theories — did Congress promulgate these rules governing the allowances that must be forsworn if the standard deduction is elected? Harris v. Commissioner, 22 T.C. 1118, 1124 et seq. (1954).

Note the link between the standard deduction and "adjusted gross income"; the deductions that are used to convert gross income into adjusted gross income are the same ones that may be deducted in addition to the standard deduction. The term "adjusted gross income" (which is relevant, among other places, in computing the deductions for medical expenses and charitable contributions, supra pages 170 and 174) is defined by §62; and a taxpayer electing the standard deduction applies it against his adjusted gross income by virtue of §63(b).

CHAPTER 4

The Splitting of Income

Section A. The Advantages of Community Property

POE v. SEABORN

282 U.S. 101 (1930)

Mr. Justice Roberts delivered the opinion of the Court.

Seaborn and his wife, citizens and residents of the State of Washington, made for the year 1927 separate income tax returns. . . .

During and prior to 1927 they accumulated property comprising real estate, stocks, bonds and other personal property. While the real estate stood in [the husband's] name alone, it is undisputed that all of the property real and personal constituted community property and that neither owned any separate property or had any separate income.

The income comprised Seaborn's salary, interest on bank deposits and on bonds, dividends, and profits on sales of real and personal property. He and his wife each returned one-half the total community income as gross income and each deducted one-half of the community expenses to arrive at the net income returned.

The Commissioner of Internal Revenue determined that all of the income should have been reported in the husband's return, and made an additional assessment against him. Seaborn paid under protest, claimed a refund, and on its rejection, brought this suit. . . .

The case requires us to construe sections 210(a) and 211(a) of the Revenue Act of 1926,* and apply them, as construed, to the interests of husband and wife in community property under the law of Washington. These sections lay a tax upon the net income of every individual. The Act goes no farther, and furnishes no other standard or definition of what constitutes an individual's income. The use of the word "of" denotes ownership. It would be a strained construction, which, in the absence of further definition by Congress, should impute a broader significance to the phrase.

The Commissioner concedes that the answer to the question involved in the cause must be found in the provisions of the law of the State, as to a wife's ownership of or interest in community property. What, then, is the law of Washington as to the ownership of community property and of community income including the earnings of the husband's and wife's labor?

The answer is found in the statutes of the State, and the decisions interpreting them.

These statutes provide that, save for property acquired by gift, bequest, devise or inheritance, all property however acquired after marriage, by either husband or wife, or by both, is community property. On the death of either spouse his or her interest is subject to testamentary disposition, and failing that, it passes to the issue of the decedent and not to the surviving spouse. While the husband

* These sections provided that the normal tax and the surtax "shall be levied, collected, and paid for each taxable year upon the net income of every individual." Substantially the same language now appears in §1(a) of the Code. — Ed.

has the management and control of community personal property and like power of disposition thereof as of his separate personal property, this power is subject to restrictions which are inconsistent with denial of the wife's interest as co-owner. The wife may borrow for community purposes and bind the community property. . . . Since the husband may not discharge his separate obligation out of community property, she may, suing alone, enjoin collection of his separate debt out of community property. . . . She may prevent his making substantial gifts out of community property without her consent. . . . The community property is not liable for the husband's torts not committed in carrying on the business of the community. . . .

The books are full of expressions such as "the personal property is just as much hers as his"; . . . "her property right in it [an automobile] is as great as his"; "the title of one spouse therein was a legal title, as well as that of the other. . . ."

Without further extending this opinion it must suffice to say that it is clear the wife has, in Washington, a vested property right in the community property, equal with that of her husband; and in the income of the community, including salaries or wages of either husband or wife, or both. A description of the community system of Washington and of the rights of the spouses, and of the powers of the husband as manager, will be found in Warburton v. White, 176 U.S. 484.

The taxpayer contends that if the test of taxability under sections 210 and 211 is ownership, it is clear that income of community property is owned by the community and that husband and wife have each a present vested one-half interest therein.

The Commissioner contends, however, that we are here concerned not with mere names, nor even with mere technical legal titles; that calling the wife's interest vested is nothing to the purpose, because the husband has such broad powers of control and alienation, that while the community lasts, he is essentially the owner of the whole community property, and ought so to be considered for the purposes of sections 210 and 211. He points out that as to personal property the husband may convey it, may make contracts affecting it, may do anything with it short of committing a fraud on his wife's rights. And though the wife must join in any sale of real estate, he asserts that the same is true, by virtue of statutes, in most States which do not have the community system. He asserts that control without accountability is indistinguishable from ownership, and that since the husband has this, quoad community property and income, the income is that "of" the husband under sections 210, 211 of the income tax law.

We think in view of the law of Washington above stated this contention is unsound. The community must act through an agent. This Court has said with respect to the community property systems (Warburton v. White, supra) that "property acquired during marriage with community funds became an acquêt of the community and not the sole property of the one in whose name the property was bought, although by the law existing at the time the husband was given the management, control, and power of sale of such property. This right being vested in him, not because he was the exclusive owner, but because by law he was created the agent of the community."

In that case, it was held that such agency of the husband was neither a contract nor a property right vested in him, and that it was competent to the legislature which created the relation to alter it, to confer the agency on the wife alone, or to confer a joint agency on both spouses, if it saw fit — all without infringing any property right of the husband. . . .

The reasons for conferring such sweeping powers of management on the husband are not far to seek. Public policy demands that in all ordinary circumstances, litigation between wife and husband during the life of the community

should be discouraged. Law-suits between them would tend to subvert the marital relation. The same policy dictates that third parties who deal with the husband respecting community property shall be assured that the wife shall not be permitted to nullify his transactions. The powers of partners, or of trustees of a spendthrift trust, furnish apt analogies.

The obligations of the husband as agent of the community are no less real because the policy of the State limits the wife's right to call him to account in a court. Power is not synonymous with right. Nor is obligation coterminous with legal remedy. The law's investiture of the husband with broad powers, by no means negatives the wife's present interest as a co-owner.*

We are of opinion that under the law of Washington the entire property and income of the community can no more be said to be that of the husband, than it could rightly be termed that of the wife. . . .

Finally the argument is pressed upon us that the Commissioner's ruling will work uniformity of incidence and operation of the tax in the various states, while the view urged by the taxpayer will make the tax fall unevenly upon married people. This argument cuts both ways. When it is remembered that a wife's earnings are a part of the community property equally with her husband's, it may well seem to those who live in states where a wife's earnings are her own, that it would not tend to promote uniformity to tax the husband on her earnings as part of his income. The answer to such argument, however, is, that the constitutional requirement of uniformity is not intrinsic, but geographic. Billings v. United States, 232 U.S. 261; Head Money Cases, 112 U.S. 580; Knowlton v. Moore, 178 U.S. 41. And differences of state law, which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity. Florida v. Mellon, 273 U.S. 12.

The District Court was right in holding that the husband and wife were entitled to file separate returns, each treating one-half of the community income as his or her respective incomes, and its judgment is affirmed.

The Chief Justice and Mr. Justice Stone took no part in the consideration or decision of this case.

NOTE

1. *Income-splitting in common law states.* In common law property states, if the husband makes an outright gift to his wife of property, such as securities or real estate, the income subsequently produced by the property is taxed to her. If he transfers the property into a joint tenancy or a tenancy in common with his wife, the income will be divided between them for tax purposes; and the same result will follow if the property is transferred into a tenancy by the entirety unless under local law the husband is entitled to all the income. See Rudick, Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy by the Entirety, 4 Tax L. Rev. 3, 25-29 (1948). But ordinarily the common law couple cannot split up the husband's *earned* income for tax purposes, as will be seen infra page 343, and splitting of investment income will be jeopardized if the husband retains control over either the transferred property or the income. With respect to both earned and unearned income, then, there was a world of difference between the Northeast and the Southwest.

2. *Eastward Ho! The spread of community property, 1939-1947.* As income tax rates rose just before and during World War II, the community property system spread. In 1939 Oklahoma enacted an optional system and Oregon did the same in 1943; both had community property neighbors and were to a degree concerned about migration for tax advantages. These statutes were repealed, however, when the Supreme Court held in Commissioner v. Harmon, infra page 344, that an optional system, not "dictated by State

* For another view of the wife's rights in community property see page 1107 infra. — Ed.

policy, as an incident of matrimony," could not claim the mantle of Poe v. Seaborn, and were later replaced by mandatory systems. During this period Hawaii, Nebraska, Michigan, and Pennsylvania* also adopted the community property system, despite their lack of historical or geographical connection with Spanish law, and adoption was under discussion in several other states, including New York. Against this background Congress enacted the "income-splitting" provisions of the Revenue Act of 1948, in the framing of which the following Treasury study was influential.

SECTION B. INCOME-SPLITTING BY CONGRESSIONAL GRACE

DIVISION OF TAX RESEARCH, TREASURY DEPARTMENT, THE TAX TREATMENT OF FAMILY INCOME

Reprinted in Hearings, House Committee on Ways and Means, 80th Cong., 1st Sess. 846-874 (1947)

This study examines alternative procedures for reducing tax differences which result from the present treatment of family income under the individual income tax. Present [i.e., pre-1948] law discriminates between families on the basis of residence, by enabling couples in community-property States to divide their earned and investment community income between separate tax returns thereby reducing their taxes through the double use of the lower rates of the progressive tax rate schedule. It discriminates also on the basis of the nature of income, by requiring earned income in noncommunity-property States to be taxed to the earner, but affording recipients of investment income numerous opportunities for splitting that income with members of their family. Finally, it discriminates between recipients of investment income by favoring families who avail themselves of opportunities to split income by gift and such devices as family trusts, corporations, and partnerships. . . .

Proposals for the elimination of the inequities inherent in the tax differences resulting from the present tax treatment of family income under the individual income tax have been considered by the Congress on several occasions in the past. These proposals reflect the different points of view from which the problem can be approached.

At one extreme is the doctrine that taxpaying ability is determined by total family income regardless of the distribution of the ownership of such income among the members of the family. Those holding this view propose that the family's total income be taxed as a unit in order that families with equal incomes and equal exemptions be subjected to equal taxes. They would require that all married couples having the same amount of net income pay the same amount of tax, regardless of whether husband or wife is the income receiver or whether both contribute to the family income in varying proportions. One procedure for giving effect to this theory is to make joint returns mandatory: to apply the graduated rates of the individual income tax against the combined income of the spouses, after requiring them to file a joint return.† An alternative procedure is to con-

* Pennsylvania's statute was held unconstitutional. Willcox v. Penn Mutual Life Insurance Co., 357 Pa. 581, 55 A.2d 521 (1947).

† In Hoeper v. Tax Commission of Wisconsin, 284 U.S. 206 (1931), the Court held that a Wisconsin statute requiring the income of husband, wife, and children under 18 years of age to be combined (if they were residing together as members of a family) in applying the progressive income tax rate schedule was an unconstitutional violation of the due process clause of the Fourteenth Amendment: "We have no doubt that, because of the fundamental conceptions which underlie our [constitutional] system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process

tinue to give married couples the option of filing joint or separate returns, but to require those filing separate returns to use a new rate schedule employing smaller brackets which would in effect take the profit out of separate returns and tend to equalize the tax on all married couples with equal incomes. Another alternative, which has recently received considerable attention and therefore is treated in this memorandum at some length, is to tax each spouse on one-half of the couple's combined income, giving each the benefits of lower rates in the graduated surtax schedule.

Another approach to this problem and one which is diametrically opposed to any of the aforementioned procedures for the handling of family income proceeds from the assumption that the family as a unit has no combined taxpaying ability per se; that its taxpaying ability is composed of the separate taxpaying abilities of its individual members; and that the taxpaying ability of each of these is determined by the amount of income of which he or she is the owner without reference to the income of the other members of the family. This approach sanctions the tax effects of income-splitting within the family provided that the transferer actually parts with title to and control of the property. This, in substance, is the rationale underlying the present income tax practice which accords each spouse the privilege of filing a separate return covering only his or her separate income. However, even those who favor basing taxes on individual legal rights to income, differ on its specific application. The large volume of litigation involving the recognition for tax purposes of income-splitting by means of trusts, assignments, etc., attests to the differences in opinion as to the degree of separation of ownership and control needed before the tax reduction effects of income-splitting can be accepted. Some deny that the differences in the matter of title to income between the community-property systems are sufficiently real to justify the present differentiation in the tax treatment of married couples with the same combined incomes. They therefore propose to tax personal-service income to the earner and to tax income derived from community-property to the spouse exercising management and control. This approach is an attempt to reconcile the tax effects of automatic division of community income practiced in community-property States with the situation in noncommunity-property States when property and control are actually transferred from one spouse to the other.

[The study went on to present in some detail a plan for income-splitting that was adopted by Congress the following year, 1948.]

Joint returns of husband and wife. The issue of geographical uniformity in federal income taxation came to a head during the Congressional hearings on the Revenue Act of 1948. Proposals for mandatory joint returns and for a legislative

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of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income." 284 U.S. at 215. Although the Wisconsin law contained a provision apportioning the tax among the members of the family, it was not discussed in the opinion. Three justices (Holmes, Brandeis, and Stone) dissented, arguing that the state's control over the consequences of marriage included the power to impose a tax on the aggregate family income, that the husband's practical control over the family property justified consolidating the separate incomes, and that consolidation was a reasonable measure to prevent tax avoidance even if it reached "innocent people." Magill, Taxable Income (rev. ed. 1945) 329-334, concludes that federal legislation taxing the family as a unit would be held constitutional, at least if the tax burden were distributed among the members of the family in proportion to their shares of the aggregate income. For a comparative study, see Oldman and Temple, Comparative Analysis of the Taxation of Married Persons, 12 Stan. L. Rev. 585 (1960); Herbert, The Uncommon Law (1935) 397 (divorce to avoid tax on consolidated family income; held, couple should be rewarded for calling attention to a grave evil: "a tax on virtue").

reversal of Poe v. Seaborn found no support, but the so-called "split-income" plan (permitting a married couple to file a joint return and pay twice the tax that would be paid by a single taxpayer having one half their joint income) gained ground rapidly. It had obvious political appeal, and the Treasury study reprinted supra implied that it would be acceptable to the Treasury. Moreover, the substantial reduction in tax that the plan would produce for married taxpayers in the common law states would be intertwined with tax reform in an appealing way, an advantage of some consequence at a time when Congress, but not the President, favored a tax cut. Alternative forms of tax reduction would have been more difficult to defend in the political arena, and they would have left the problem of geographical discrimination unsolved. Against this background, and with the community property system threatening to sweep the country, it is not surprising that the split-income plan was enacted into law by the Revenue Act of 1948.*

The statutory scheme is simplicity itself. Husband and wife may file a joint return† on which they aggregate their income and deductions; this procedure is open to them even though one spouse has no income or deductions. Their status is determined at the end of the taxable year; if there is a decree of divorce or of legal separation at that time, they are not to be considered as married. §6013(d). For the effect of invalid divorces and other state law complications, see Borax v. Commissioner, 40 T.C. 111 (1963). It has been held that separation under an interlocutory decree of divorce does not bar the filing of a joint return. Rev. Rul. 57-368, 1957-2 C.B. 896. If husband or wife dies during the taxable year, a joint return may be executed by the decedent's executor or administrator and the surviving spouse; if no representative has been appointed for the decedent before the return is due, a joint return may be executed by the surviving spouse, but the executor or administrator, upon his appointment, may disaffirm the joint return by filing a separate return within one year after the return was due. §6013(a)(3). Joint returns cannot be filed if either husband or wife is a nonresident alien or if they have different taxable years. §6013(a).

The tax on a joint return is determined by computing a tax at the usual rate on one half of the aggregate taxable income, and then doubling that amount. §2(a). The result is that the tax paid by husband and wife on a joint return is twice what a single person would pay on one half their taxable income. Liability for the tax is joint and several. §6013(d)(3). This joint and several liability is for the tax actually due on the true aggregate taxable income, not merely for the amount of tax reported on the return itself; and it includes liability for interest on any deficiency and penalties for negligence or fraud if applicable, even if the misconduct is attributable to only one spouse.

Because the tax on a joint return is twice what would be paid on a separate return reporting one half the aggregate income, a married couple will rarely find any advantage in filing separate returns.‡ (Note that a married couple who would

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* Once the privilege of income-splitting was extended to couples in common law states, the "new" community property states lost their taste for Spanish law and repealed their statutes. See Note, Epilogue to the Community Property Scramble: Problems of Repeal, 50 Colum. L. Rev. 332 (1950).

† Joint returns for husband and wife were authorized by pre-1948 law, but the aggregate net income was taxed as though it were the income of a single taxpayer. A married couple might derive an advantage from joint filing, however, if one spouse had excessive losses or expenses; instead of being wasted on a separate return, they could be applied on a joint return against the income of the other spouse. See Shelmerdine v. Commissioner, 24 B.T.A. 833 (1931).

‡ The filing of a separate return by a married man was regarded as a badge of fraud in Noell v. Commissioner, 22 T.C. 1035 (1954), where the husband transferred much of his property to his wife, without consideration, and then filed a separate return. Because the tax thus com-

be entitled to an optional standard deduction of $1000 on a joint return cannot improve their position by separate returns; the usual limit of $1000 is reduced to $500 for a married person filing a separate return. §141.) There are a few exceptions to the use of joint returns by married couples, aside from the case of the spouse who refuses to sign: (1) If the income of husband and wife is divided approximately equally, and each suffers a net capital loss, separate returns will permit each one to use $1000 of his capital loss against ordinary income; on a joint return, however, the aggregate deduction under §1211(b) would be only $1000. (2) If income is divided about equally and one spouse pays substantial medical expenses, separate returns will reduce the "adjusted gross income" of the one who paid the medical expenses and thus increase the medical deduction. But this advantage may be offset by a lower ceiling on the deduction for charitable contributions. (3) Since neither party to a joint return can be claimed as a dependent by a third taxpayer, by virtue of §151(e)(2), a separate return may be preferable for some lower-bracket taxpayers. An example is a married student who is supported by his father and whose wife's adjusted gross income is $2000. Under the tax table of §3, the tax on a separate return is $163; on a joint return, $122. By paying the higher tax, however, they make it possible for the father to claim the son as a dependent on his return.

Under the Revenue Act of 1948, an election to file a joint return, as well as a failure to elect, was irrevocable after the time for filing the return expired. The statute was amended in 1951, however, to permit a joint return to be filed after a separate return was filed even though the time for filing has expired. §6013(b). But an election to file a joint return is irrevocable, unless it was filed by the surviving spouse of a decedent and the decedent's representative disaffirms under §6013(a)(3). See Spanos v. United States, 323 F.2d 108 (4th Cir. 1963).

Ordinarily a joint return is easily recognized by the fact that both spouses sign, although on occasion an intent to file a joint return has prevailed over the fact that only one spouse signed. Lane v. Commissioner, 26 T.C. 405 (1956) (husband agreed to sign but failed to do so because of physical handicap and excessive use of alcohol); Ferguson v. Commissioner, 14 T.C. 846 (1950) (husband filed return purporting to report joint income; wife did not sign, but failed to file separate return); but see Hennen v. Commissioner, 35 T.C. 747 (1961) ("tacit consent" rule inapplicable where husband signed both names, there was no evidence of wife's consent, and Commissioner asserted that return was not a joint return). Conversely, it is sometimes possible for one of the spouses to repudiate his or her signature. Hickey v. Commissioner, ¶55,149 P-H Memo T.C. (wife signed only to avoid exciting husband, a cardiac patient); Furnish v. Commissioner, 262 F.2d 727 (9th Cir. 1958) (husband woke wife up at 2:00 A.M. and told her, harshly, to sign return in blank; she signed out of "fear"); but see Aylesworth's Estate v. Commissioner, 24 T.C. 134 (1955) (wife signed a day after husband flew into violent rage because of her refusal to sign; court concluded her signature was "voluntary, though perhaps distasteful").

Because of the joint and several liability mentioned above, the representative of a decedent may be reluctant to file a joint return for the decedent and surviving spouse for the year of death, as permitted by §6013(a)(3), since the tax savings to the estate may be outweighed by a tax deficiency if it turns out that the surviving spouse understated his or her income. See In re Floyd's Estate, 43 A.F.T.R. 1301 (Orphans' Court, Delaware County, Pa., 1951), ordering a co-executrix to sign a

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puted was much larger than would have been due on a joint return, the court inferred that the taxpayer's purpose was to shield the assets transferred to his wife from the tax liability that she would have incurred by executing a joint return. The wife was held liable as a "transferee." Infra page 929.

joint return in order to obtain the benefits of income-splitting for the estate of a deceased taxpayer with respect to income prior to his death; page 1352 infra.

See generally Ritz, The Married Woman and the Federal Income Tax, 14 Tax L. Rev. 137 (1959).

Heads of households. Although the 1948 Act produced geographical uniformity by giving married couples in the common law states the opportunity to split their income, it brought to the common law states a tax disparity (which had formerly existed only in the community property states) between married couples and unmarried persons with the same income and similar family responsibilities. This disparity led Congress in 1951 to enact the head-of-household provision, §1(b), under which a special rate schedule (embodying half the tax reduction available to a married couple filing a joint return) is granted to an unmarried person if he (or she) (1) "maintains as his home a household which constitutes . . . the principal place of abode, as a member of such household" of an unmarried child or grandchild or of any person (with minor exceptions) for whom the taxpayer is entitled to a dependency deduction, or (2) "maintains a household which constitutes . . . the principal place of abode" of a parent who is claimed as a dependent. On the meaning of "home," "household," and "principal place of abode," see Brehmer v. United States, 191 F. Supp. 421 (D. Minn. 1961); Reardon v. United States, 158 F. Supp. 745 (D.S.D. 1958); Smith v. Commissioner, 332 F.2d 671 (9th Cir. 1964). See also Pechman, Individual Income Tax Provisions of the 1954 Code, 8 Nat. Tax J. 114, 126-128 (1955).

Surviving spouse with dependent child. Along with the head of household provision, Congress in 1951 enacted §2, which extends the tax benefit of a joint return to a widow or widower for the two taxable years following the year of his or her spouse's death, providing the survivor "maintains as his home a household which constitutes . . . the principal place of abode (as a member of such household)" of a child for whom he is entitled to a dependency deduction. After the two-year period, the surviving spouse may qualify as a "head of household" under §1(b), and thus receive the tax concession available to persons in that status.

Distribution of returns among family units. Of the 61.5 million income tax returns filed during 1962, 36.7 million were joint returns of husbands and wives, 3.8 million were separate returns of husbands and wives, 1.6 million were "head of household" returns, 0.3 million were "surviving spouse" returns, and 19.1 million were returns of single persons (other than "heads of households" and "surviving spouses").

Dependency exemptions. The taxpayer is allowed by §151(e) an exemption of $600 (deducted in computing taxable income) for each "dependent" whose gross income is less than $600 for the taxable year. Because the dependent's gross income is the critical factor rather than his adjusted gross or taxable income, a dependent with $600 or more of rental or business income is disqualified even though he suffered a loss for the year because his business deductions exceeded his gross income. Gooch v. Commissioner, 21 T.C. 481 (1954). Because the dependency exemption is not merely reduced but lost entirely if the gross income limit is violated, the taxpayer may lose as much as $420 (70 per cent, the maximum 1965 rate, of $600) if an otherwise qualified dependent realizes a few extra dollars of gross income.

Such an inadvertent loss of the dependency exemption is less common now than it was in the past, because in 1954 Congress enacted §151(e)(1)(B), eliminating the gross income limit if the dependent is a child of the taxpayer and is either under the age of 19 or a full-time student (as defined). See Bayley v. Commissioner, 35 T.C. 288 (1960) (intern in hospital is not a full-time "student"). This exception — which was presumably enacted to encourage summer employment of students —

is in turn subject to a restriction: it is denied if the dependent is married and files a joint return with his spouse. The result is that a married student who otherwise qualifies as a dependent must forego the tax benefits of a joint return if he wishes to preserve his father's dependency deduction.

The term "dependent" is defined by §152 by reference to two criteria:*

(a) *Relationship.* A "dependent" must be related to the taxpayer by blood, marriage, or adoption within the degrees specified by §152(a)(1)-(8), or meet the special requirements of §152(a)(9) or (10). Section 152(a)(9), relating to a person who lives with the taxpayer as a member of his household, was enacted in 1954, evidently to permit foster children to qualify as dependents. It seemed at first, however, to hold out some hope for a bachelor who wished to claim a "friend" as a dependent. The Tax Court held in Turnipseed v. Commissioner, 27 T.C. 758 (1957), however, that an illicit relationship did not qualify under §152(a)(9); one judge concurred on the ground that the taxpayer was not supporting the lady, since she was supporting herself. The Tax Court's instincts about the meaning of §152(a)(9) were confirmed by the enactment in 1958 of §152(b)(5), providing that an illicit relationship does not make a "household."

(b) *Support.* The taxpayer must furnish over half of the "support" for the taxable year of the person claimed as a dependent. The term "support" is not defined by the Code, but the Regulations supply some content to the concept. Regs. §1.152-1(a)(2) ("food, shelter, clothing, medical and dental care, education, and the like"; items supplied in kind are to be taken at fair market value). See also Flower v. United States, 52 A.F.T.R. 1383 (W.D. Pa. 1957) ($1400 Chris-Craft boat and $130 rifle for boy of 13 not part of "support"); Rev. Rul. 56-399, 1956-2 C.B. 114 (cost of automobile, as distinguished from cost of transportation, not included in "support"); Limpert v. Commissioner, 37 T.C. 447 (1961) (payments to babysitter included in computing cost of child's support); Bartsch v. Commissioner, 41 T.C. No. 83 (1964) (fair market value of taxpayer's services in caring for aged and infirm mother not included in "support," two judges dissenting); I.T. 3834, 1947-1 C.B. 29 (subsistence allowance received by veteran under "G. I. Bill of Rights" not part of support if not so used by him); Dick v. United States, 218 F. Supp. 839 (E.D. Wis. 1963) (father used child's earnings for child's support; held, no dependency exemption). A determination that a disputed item is part of the claimed dependent's "support" may establish that one person rather than another (e.g., a child's grandfather rather than his father) is entitled to the dependency exemption, or it may defeat the claim entirely (e.g., if the disputed item was supplied by the dependent himself). Note also that an expense may lay the basis for a dependency exemption even though the taxpayer has deducted it under §163 and §164 (mortgage interest and real estate taxes), §214 (child care expenses), or §213 (medical expenses). See Limpert v. Commissioner, supra.

A scholarship received by a student is not taken into account in determining whether his parents supplied more than half his support. See Ide v. Commissioner, 40 T.C. 721 (1963) (tuition and books received by college student under Naval R.O.T.C. training program; held, scholarship); Rev. Rul. 58-338, 1958-2 C.B. 54 (value of room and board supplied by nursing school to student nurses qualified as scholarship).

There is some authority for assuming that a person who supplies more than half the aggregate support of a group of persons (e.g., three children) has supplied more than half the support of each one, as well as for the theory that the cost of maintaining a household inures equally to the benefit of each occupant; it is by

* An alien cannot be a "dependent" unless he is a resident of the United States, a contiguous country, the Canal Zone, or Panama, or is a child of the taxpayer who meets the special requirements of §152(b)(3)(A) or (B).

no means clear, however, that the statutory provisions support these administratively appealing ways of avoiding troublesome problems of proof, and some cases seem to require more precision. Dunn v. Commissioner, ¶63,189 P-H Memo T.C.; Vance v. Commissioner, 36 T.C. 547 (1961); Fisher v. Commissioner, 16 T.C. 1144 (1951).

Before 1954, the Code was inflexible in requiring the taxpayer to contribute "over half" of the dependent's support. The exemption was often lost because two or more taxpayers contributed in equal proportions, particularly where several children were supporting a parent. See, e.g., Russoniello v. Commissioner, 21 T.C. 828 (1954). The 1954 Code, by §152(c), authorizes a "multiple support agreement." If more than half of the dependent's support was supplied by two or more otherwise eligible persons, those who contributed over 10 per cent may join in an agreement to designate one of their number to take the deduction. They can rotate the designation annually if they wish, or assign it repeatedly to the person who will derive the most tax benefit from claiming the exemption.

By virtue of §152(b)(4), payments to a wife that are deductible by the husband under §71 (alimony, etc.) are not to be treated as payments by him for the support of any dependent. On the other hand, payments that he cannot deduct under §71 because they are allocable to the support of minor children within the doctrine of the *Lester* case, supra page 184, may serve to establish a dependency exemption for him, but he will find it difficult to prove his claim if some of the support is supplied by the wife and she will not co-operate in making the evidence of their respective contributions available to him. Supra page 184. What is the status of amounts that are not explicitly designated as child support payments, but that nevertheless cannot be deducted under §71 (e.g., lump sum payments) if used by the wife to support the children?

It will be noted that the fact that a taxpayer is entitled to an exemption of $600 in respect of a qualified dependent does not deprive the dependent of the $600 personal exemption as to his own income. This "doubling up" of exemptions is especially important in the case of children who are under 19 or are full-time students, since they may be claimed as dependents without regard to the $600 gross income of §151(e)(1)(A). The child's parents are entitled to a dependency exemption if they supply more than half his support, and he will pay no income tax unless his adjusted gross income exceeds $900 (the sum of his personal exemption and the minimum standard deduction). A comparable phenomenon can occur with respect to other dependents, but the potential tax saving is smaller because the dependency exemption will be lost if the dependent's gross income is $600 or more.

The term "dependent" is important outside of the dependency exemption area of §151; it is employed, for example, by §213 (medical expenses of dependent deductible by taxpayer), §214 (expenses of caring for certain "dependents"), §1(b)(2)(A)(ii) (definition of "head of household"), §2(b)(1)(B) (definition of "surviving spouse"), etc. A person can be a "dependent" for these purposes if the requisite relationship and amount of support is established; the $600 gross income provision is a restriction on the dependency exemption, not part of the definition of the term "dependent."

In 1960, §170(d) was amended to allow a charitable contribution deduction for the cost (subject to limitations) of maintaining an elementary or secondary school student in the taxpayer's household under a charitable organization's program for providing educational opportunities in private homes. The child need not be a dependent or relative of the taxpayer, but the deduction, although achieved through the mechanism of §170, resembles the dependency exemption.

Exemptions based on age and blindness. The taxpayer is entitled to an extra

personal exemption of $600 if he reaches the age of 65 before the end of the taxable year. On a joint return, if both spouses are 65 or over, there will be four exemptions, with the result that no tax will be payable unless their adjusted gross income exceeds $3000 (the sum of their minimum standard deduction of $600 and their personal exemptions of $2400). Other tax concessions based on age are the exclusion of social security benefits from gross income and the related credit for "retirement income" (supra page 202), the relaxation of the limits on the medical expense deduction (supra page 170), and §121 (tax-free sale of residence by person 65 or over, infra page 474).

Section 151(d) provides an additional exemption for a taxpayer who is blind (as defined) at the end of the taxable year. Proposals to extend the same concession to persons who are physically handicapped in other ways have been made from time to time, but not enacted. At several other points in the Code, however, concessions are based on physical disability, regardless of its source. See §213(g)(3) (defining "disabled" for purpose of applying special limitation on medical expense deduction), §214 ("mentally or physically defective"), §152(a)-(10)(B) ("institutional care required by reason of a physical or mental disability").

See articles by various authors on "Taxation of the Aged," in 1959 Tax Revision Compendium (House Committee on Ways and Means) 539-578; Chen, Income Tax Exemptions for the Aged as a Policy Instrument, 16 Natl. Tax J. 325 (1963).

Economic effect of personal and dependency exemptions. The personal and dependency exemptions eliminate persons at the lowest income levels from the tax rolls, supply a degree of progression in the effective rate of tax beyond what is built into the rate schedule itself, differentiate among taxpayers according to the size of their family units, and grant special concessions to the aged and the blind.

For a family of four, it has been estimated that a bare subsistence budget would have required $2500 in 1959; a minimum health and decency budget, $3600; and a minimum comfort budget, $4400.* For the same year, the hypothetical family would have paid no federal income tax on adjusted gross income of less than $2700; but the tax would have been $173 and $317 at the minimum health and decency and minimum comfort budget levels. In 1965, with the newly enacted "minimum standard deduction" and rate reductions — but assuming no change in the cost of living — the comparable tax bills will be $95 (minimum health and decency budget) and $211 (minimum comfort budget). As to the number of returns with minimum amounts of adjusted gross income, 4 million (out of 61.5 million) returns filed in 1962 fell in the under $600 adjusted gross income class, and another 6.9 million reported adjusted gross income of $600 to $1500.

Changes in the personal exemptions have a drastic impact on the coverage and yield of the federal income tax. An increase in the exemption from $600 to $700 in 1963 would have resulted in a reduction in taxable returns of 2 million and a loss of $3.2 billion in revenue, and an increase to $800 would have cost another $2.9 billion, according to a Treasury estimate. To recoup these losses of revenue by a proportionate rate increase, a 7 to 13 per cent increase would have been required; alternatively, a 100 per cent rate on all taxable income above $22,000 or $15,000 would have done the trick.

The following table sets out the number of exemptions claimed on income tax returns for 1961:

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* Samuelson, Economics (5th ed. 1961) 113-114; see also Lamale and Stotz, Interim City Worker's Family Budget, 1960 Monthly Labor Review 785.

	Returns	Exemptions
	(in millions)	
Taxpayer's exemptions:		
Taxpayer and spouse	61.5	99.4
Age 65 or over	5.3	6.8
Blindness	0.1	0.1
Dependency exemptions	30.9	71.2
Total	61.5	177.5

Comparative tax burden: Separate, joint, and head of household returns. The tax burden on domestic units of various types is compared in the following table, which gives effect to the personal and dependency exemptions and the optional standard deduction, as well as to the varying rates applicable to separate, joint, and head of household returns:

FEDERAL INCOME TAX ON FAMILY UNITS OF VARIOUS TYPES *

Adjusted gross income	*Single person*	*Head of household, one dependent*	*Married couple*	*Married couple, two dependents*
$ 2,500	$ 244	$ 128	$ 128	——
5,000	671	534	501	$ 290
10,000	1,742	1,456	1,342	1,114
25,000	7,730	6,348	5,276	4,892
50,000	21,630	18,610	15,960	15,360
100,000	54,386	48,892	43,860	43,140

* 1965 rates on adjusted gross income less standard deduction and exemptions.

The reasonableness of these burdens might be judged by comparing the relative incomes required by families of different sizes to attain the same standard of living. According to a 1947 study by the Treasury, the same standard of living is attained by a single person living alone, a married couple with no dependents, and a married couple with two dependents at income levels in the ratio of about 70:100:150.* These ratios also suggest that the uniform $600 exemption of existing law is too low for a single person living alone and too large, on a comparative basis, for married couples with two or more children; and that variations in the cost of living would be more accurately reflected with exemptions of $800 for a single person, $1200 or $1600 for a married couple, and $400 for each child.

It should also be noted, however, that these statistical comparisons are of limited validity. According to the 1947 Treasury study which preceded enactment of the joint return "split income" provision of 1948:

> The use of these ratios for the purpose of appraising alternative methods of solving the family income problem is subject to several important limitations. It appears, for example, that a married couple does not need twice the money income of a single person to attain the same standard of living because the housewife contributes a substantial amount of real income to the family. However, the income tax applies largely to money incomes and not real incomes. The determination of the relative taxpaying abilities in accordance with the above-indicated ratios would seem to involve the taxation of the real income added by the housewife. Another limitation stems from the fact . . . that the data used to obtain the above relative income ratios pertain to relatively low-income groups (primarily under $5,000), whereas the family income problem under consideration

* Division of Tax Research, Treasury Department, Individual Income Tax Exemptions (1947); see also Froeder, Estimating Equivalent Incomes or Budget Costs by Family Type, Monthly Labor Review, Nov. 1960, p. 1197, reaching a similar result.

pertains primarily to middle- and upper-income groups. Finally, the proportion of income used for consumption purposes tends to decrease and savings tend to increase as income increases. Thus, the ratios of relative income needed to obtain comparable levels of living would have less and less applicability, as an index of relative taxpaying abilities, as a larger and larger proportion of income is saved. [Division of Tax Research, Treasury Department, The Tax Treatment of Family Income, in Hearings on Revenue Revisions, 1947-48, House Committee on Ways and Means, 80th Cong., 1st Sess., 844, 852.]

References. On the taxation of family income, including joint returns, rate schedules, personal and dependency exemptions, see the papers by various authors, in 1959 Tax Revision Compendium (House Ways and Means Committee) 473-538; Groves, Federal Tax Treatment of the Family (Brookings Institution, 1963); Oldman and Temple, Comparative Analysis of the Taxation of Married Persons, 12 Stan. L. Rev. 585 (1960).

Section C. Income-Splitting by Private Arrangement

Before 1948, when Congress granted to married couples the privilege of splitting their income for tax purposes by filing joint returns, almost every conceivable method of accomplishing the same result by private arrangement was essayed by taxpayers. The materials that follow illustrate the most popular of these plans and the judicial, administrative, and legislative responses that they evoked.

Although the pressure to devise a private arrangement for income-splitting was greatly reduced when Congress enacted the income-splitting joint return provision of 1948 and the head-of-household provision of 1951, tax advantages can still be enjoyed if income can be split with children, other relatives, trusts, etc. The greater the number of individuals and entities among whom a given amount of income can be divided, the greater the tax savings. Moreover, the optional standard deduction may lend additional enchantment to income-splitting. Thus, a married couple with two dependents is entitled to a maximum standard deduction of $1000 on a joint return; if income is divided so that husband and wife file a joint return and their two dependents each file a separate return, the aggregate of their standard deductions may rise to $3000. The amount of tax that may be saved by a married couple with two dependents by splitting various amounts of adjusted gross income equally among all members of the family is shown by this table:

EFFECT OF INCOME-SPLITTING

Tax on Married Couple With Two Children *

Adjusted gross income	*Income reported on joint return*	*Income reported on 3 returns*†
$ 10,000	$ 1,114	$ 985
25,000	4,892	3,717
50,000	15,360	10,232
100,000	43,140	31,420
250,000	143,600	118,104

* 1965 rates applied to taxable income (adjusted gross income less optional standard deduction and exemptions)

† One-half of adjusted gross income reported on a joint return by parents; one-quarter by each child on a separate return.

As will be seen, income may be split not only with children and other members of the family, but also with trusts and other entities; moreover, business income

may be spread out among a number of proprietorships, partnerships, and corporations. The impact of thirty years of income-splitting tactics upon the law of federal income taxation is incalculable. The judicial doctrines worked out during this period have penetrated to every crevice of our tax structure, so that the relationships of employer and employee, of parent corporation and subsidiary, of corporation and stockholder, of philanthropist and charity, and of landlord and tenant are all influenced by the cases that follow.

For comprehensive studies of the income-splitting area, see Lyon and Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case, 17 Tax L. Rev. 295 (1962) (reprinted, with some revisions, from 1962 So. Calif. Tax Inst. 47); Rice, Judicial Trends in Gratuitous Assignments to Avoid Federal Income Taxes, 64 Yale L.J. 991 (1955); Soll, Intra-Family Assignments: Attribution and Realization of Income, 6 Tax L. Rev. 435 (1951) and 7 id. 61 (1951). More specialized studies are cited hereafter.

1. *Gifts*

LUCAS v. EARL
281 U.S. 111 (1930)

MR. JUSTICE HOLMES delivered the opinion of the Court.

This case presents the question whether the respondent, Earl, could be taxed for the whole of the salary and attorney's fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife which we shall mention. The Commissioner of Internal Revenue and the Board of Tax Appeals imposed a tax upon the whole, but their decision was reversed by the Circuit Court of Appeals, 30 F. (2d) 898. A writ of certiorari was granted by this court.

By the contract, made in 1901, Earl and his wife agreed

> that any property either of us now has or may hereafter acquire . . . in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds, issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship.

The validity of the contract is not questioned, and we assume it to be unquestionable under the law of the State of California, in which the parties lived. Nevertheless we are of opinion that the Commissioner and Board of Tax Appeals were right.

The Revenue Act of 1918 . . . imposes a tax upon the net income of every individual including "income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid," §213(a) [§61(a)]. . . . A very forcible argument is presented to the effect that the statute seeks to tax only income beneficially received, and that taking the question more technically the salary and fees became the joint property of Earl and his wife on the very first instant on which they were received. We well might hesitate upon the latter proposition, because however the matter might stand between husband and wife he was the only party to the contracts by which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone. But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable

construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Judgment reversed.

THE CHIEF JUSTICE took no part in this case.

NOTE

1. *Mrs. Earl's tax status.* Was Mrs. Earl also taxable on the income in question? Suppose Mrs. Earl had paid for Mr. Earl's legal education, his law library, etc., in return for an assignment of 50 per cent of his professional earnings either for a stated period or for life. Would the income then be taxed to Mr. Earl?

In Wilkinson v. United States, 304 F.2d 469 (Ct. Cl. 1962), the court held that a lawyer who had purchased a 45 per cent interest in another lawyer's rights under a contingent fee contract for $12,000 in 1938 was taxable on his share ($191,000) when the contingency was satisfied in 1951, although he had in turn assigned his claim to a charitable institution.

2. *Do-it-yourself community property.* In Commissioner v. Harmon, 323 U.S. 44 (1944), the Supreme Court held that a 1939 Oklahoma statute permitting husband and wife to elect to be governed by a community property system was not effective for federal income taxation. The Court said that the existence of an option resulted in a status similar to that in Lucas v. Earl, "where by contract future income of the spouses was to vest in them as joint tenants" and distinguished Poe v. Seaborn, where "the court was not dealing with a consensual community but one made an incident of marriage by the inveterate policy of the State." Mr. Justice Douglas dissented in an opinion joined by Mr. Justice Black, arguing that a decision to move to or marry in a community property state is as "consensual" as filing an election under the Oklahoma statute. He also pointed out that income from community property was divisible under Poe v. Seaborn even though in some community property states the spouses have the power to convert community property into separate property and vice versa. Finally:

> I do not mean to defend Poe v. Seaborn. I only say that if we are to stand by it, we should not allow it to become a "vested" interest of only a few of the states. The truth of the matter is that Lucas v. Earl and Helvering v. Clifford [infra, p. 372] on the one hand and Poe v. Seaborn on the other state competing theories of income tax liability. [323 U.S. at 56.]

G.C.M. 27026

1951-2 C.B.7

An opinion is requested as to the treatment for Federal income tax purposes of the proceeds derived from public entertainments conducted for the benefit of charitable organizations.

It is a common practice for those engaged in the business of promoting sporting events, or other forms of public entertainment, to designate events conducted on certain days as "charity" events, the net proceeds being turned over to specific charitable organizations.

It is a well-established principle, based on decisions of the Supreme Court of the United States, that an assignment of income by the person who earns it, or is otherwise entitled to it, does not relieve him from tax on such income. When a person who is in the business of promoting sporting events, or other public entertainments, enters into an agreement with a charitable organization under the terms of which the facilities of the former are operated by him as agent for the

charitable organization, and all the proceeds from the event less expenses are received by or on account of the latter, the promoter is in effect assigning to the charitable organization earnings derived by him from the operation of the event. To allow the promoter in these circumstances to exclude such amounts from his gross income would be to give effect to form rather than substance, and would permit circumvention of the specific statutory limitations, contained in [§170(b)(1)], on the amount of charitable contributions which is deductible in computing net income. This office is accordingly of the opinion that if a professional promoter would, in the absence of an agreement between the parties, be entitled to the proceeds of an event, such agreement will not operate to permit him to exclude the proceeds of the event from his income for Federal income tax purposes.

It is recognized, however, that there are instances in which a charitable organization is itself the promoter of an event designed to produce income to be used for its purposes. Bazaars, amateur productions, and sporting events are, of course, frequently promoted by such organizations. If the charitable organization is actually the promoter of an event, the fact that services and property are contributed or facilities loaned to the organization does not, of itself, result in tax to the contributor or lender.

Determination of whether the charitable organization is in substance the beneficiary of profits earned by a professional promoter of an event, or whether it is itself the promoter, must depend on the particular facts in each case, considering the realities of the situation.

NOTE

1. *G.C.M. 27026 as applied.* Bearing in mind what Mr. Justice Holmes said of "attenuated subtleties" in Lucas v. Earl, how would you conduct negotiations on behalf of a promoter to avoid an imputation of income to him?

Is the principle of this ruling applicable only to promoters, or does it embrace all performers? See Regs. §1.61-2(c). A few years before this regulation was issued there was a spirited exchange between Assistant Attorney General (later Mr. Justice) Jackson and several members of a joint Congressional committee over a Treasury ruling that the proceeds of Mrs. Roosevelt's radio broadcasts, which were paid to charities, were not taxable to her. The basis of the ruling was thus stated by Mr. Jackson.

> One who earns a salary or wages or has income from invested property cannot assign that income nor order it to be paid to a person or corporation so as to avoid a tax merely by routing his income so as not to pass through his hands. But this doctrine of constructive receipt of income cannot be used to create income when there is no income, and has never been used to justify a tax on services devoted to charity. Mrs. Roosevelt declined to work for money and was only willing to serve for charity's sake. It was and is my opinion that such benefit broadcasts do not result in taxable income. [Hearings Before the Joint Committe on Tax Evasion and Avoidance, 75th Cong., 1st Sess., p. 4, 426 (1937).]

Are similar practices prevented by the subsequently issued regulation cited above? See Rev. Rul. 71, 1953-1 C.B. 18.

What is the status of a salary paid for services to a member of a religious order who is bound by an oath of poverty and transfers his entire earnings to his ecclesiastical superior? See statement of Paul Blanshard (on behalf of Protestants and Other Americans United for Separation of Church and State), in Hearings, Technical Amendments to Internal Revenue Code, Subcommittee of House Ways and Means Committee, 84th Cong., 2d Sess. 46, 54 (1956).

Under G.C.M. 27026, could a promoter contribute his services to a group of friends who are sponsoring a "benefit" for an indigent prizefighter? For the promoter's son? For the promoter himself?

2. *Benefits for the Red Cross.* Section 114, enacted in 1952, excludes from gross income the proceeds of certain sports events, if the taxpayer is a corporation and turns the proceeds over to the American Red Cross. What does this provision accomplish that is not permissible under G.C.M. 27026 or Regs. §1.61-2(c)?

TESCHNER v. COMMISSIONER

38 T.C. 1003 (1962)

[The taxpayer submitted one of the winning entries in a contest sponsored by Johnson & Johnson, Inc., in cooperation with Mutual Benefit Life Insurance Company, in which prizes were awarded for the best essays beginning "A good education is important because . . ." The prizes were 49 fully paid annuity contracts with face amounts ranging from $10,000 to $1000. The rules of the contest required contestants over the age of 17 years and 1 month to designate a person under that age to receive the annuity contract in the event the contestant's entry was successful. In accordance with this rule, the taxpayer had designated his daughter (age 7) when he submitted his essay, and she was awarded a $1500 annuity.]

TRAIN, Judge: While the taxability of prizes and awards may have been in doubt prior to the enactment of the Internal Revenue Code of 1954, it is now clear that they are includible in gross income, with certain exceptions not here applicable. Sec. 74 I.R.C. 1954. The sole question in this case is whether the prize (annuity policy) is taxable to petitioners.

Respondent, relying on Lucas v. Earl, 281 U.S. 111 (1930), and Rev. Rul. 58-127, 1958-1 C.B. 42, contends that the annuity policy which Karen received is includible in petitioners' gross income. Respondent states on brief that the issue here "is whether a prize attributable to a taxpayer's contest efforts, which, if received by him, would constitute taxable income in the nature of compensation for services rendered, may be excluded by him because paid to his designee." Respondent declares his theory of the case to be "that whenever *A* receives something of value attributable to services performed by *B*, *B*, the earner, is the proper taxpayer."

Petitioners contend that the value of the annuity policy should not be included in their gross income because they did not receive anything either actually or constructively and never had a right, at any time, to receive anything that could have been the subject of an anticipatory assignment or similar arrangement.

We agree with the petitioners.

In the instant case, we are not confronted with the question of whether the prize is income. The sole question is whether it is the petitioners' income for tax purposes. Certainly, it was Paul's effort that generated the income, to whomever it is to be attributed. However, as we have found, he could not under any circumstances whatsoever receive the income so generated, himself. He had no right to either its receipt or its enjoyment. He could only designate another individual to be the beneficiary of that right. Moreover, under the facts of this case, the payment to the daughter was not in discharge of an obligation of petitioners. Cf. Douglas v. Willcutts, 296 U.S. 1 (1935). At age 18, Karen will be entitled to $1,500. She can use that money, in her uncontrolled and unfettered discretion, for any purpose she chooses. Nor does respondent here contend that petitioners received income by virtue of a satisfaction of an obligation to support. Finally, there is no evidence whatsoever that the arrangement here involved was a sham or the product of connivance.

As pointed out above, respondent relies, in part, on Rev. Rul. 58-127, supra, and a consideration of that ruling is useful because it reveals the error into which

the respondent has here fallen. Under the circumstances stated by that ruling, the taxpayer prepared and submitted a winning entry in an essay contest. Pursuant to the terms of that contest, the taxpayer received a check payable to his child, the use of which was entirely without restriction imposed by the sponsors of the contest. The respondent ruled that, under such circumstances, the amount of the prize was includible in the gross income of the taxpayer. While the facts set out in that ruling do not disclose whether the taxpayer could himself have received the prize, it would seem that in all salient respects the facts therein are identical to those before us.

In his ruling, the respondent declared, "The basic rule in determining to whom an item of income is taxable is that income is taxable to the one who earns it." If by this statement the respondent means that income is in all events includible in the gross income of whomsoever generates or creates the income by virtue of his own effort, the respondent is wrong. If this were the law, agents, conduits, fiduciaries, and others in a similar capacity would be personally taxable on the proceeds of their efforts. The charity fund-raiser would be taxable on sums contributed as the result of his efforts. The employee would be taxable on income generated for his employer by his efforts. Such results, completely at variance with every accepted concept of Federal income taxation, demonstrate the fallacy of the premise.

If, on the other hand, the respondent used the term "earn," not in such a broad sense, but in the commonly accepted usage of "to acquire by labor, service, or performance; to deserve and receive compensation" (Webster's New International Dictionary), then the rule is intelligible but does not support the conclusion reached by the respondent either in the ruling in question or in the case before us. The taxpayer there, as here, acquired nothing himself; he received nothing nor did he have a right to receive anything.

In Rev. Rul. 58-127, supra, respondent relied heavily, as he does here, on Helvering v. Horst, 311 U.S. 112 (1940), especially the language of the opinion to the effect that — "The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it." The respondent's reliance on this language is misplaced. The power of disposition assumes possession or the right of possession. To dispose is to part with. Where there is neither possession nor the right to possession, there can be no disposition. In Helvering v. Horst, supra, the taxpayer, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as gifts to his son who in the same year collected them at maturity. The language of the Court, quoted above and relied upon by respondent, mistakenly we believe, must be read in relation to the facts then before the Court. In this connection, the Court in *Horst* stated unequivocally: "The question here is, whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment." Plainly, here, petitioners have not given away any *right* of theirs whatsoever. Further, in *Horst,* at page 119, the Supreme Court stated:

> The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. . . . The tax laid . . . upon income "derived from . . . wages, or compensation for personal service, . . . in whatever form paid, . . ." . . . cannot fairly be interpreted as not applying to income derived from interest or compensation when *he who is entitled to receive it* makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received. [Emphasis supplied.]

In Lucas v. Earl, 281 U.S. 111 (1930), upon which respondent heavily relies, the Supreme Court refused to allow a husband to escape taxes on his income by way of salaries and attorney fees through a contractual arrangement by which he and his wife were to receive, hold, and own such earnings as joint tenants. The Court declared that tax on a salary could not be avoided by the person earning the salary by anticipatory arrangements and contracts. Shortly thereafter, in Poe v. Seaborn, 282 U.S. 101, 117 (1930), the Supreme Court stated:

> In the *Earl* case . . . the husband's professional fees, earned in years subsequent to the date of the contract, were his individual income . . . The very assignment in that case was bottomed on the fact that the earnings would be the husband's property, else there would have been nothing on which it could operate. That case presents quite a different question from this, because here, by law, the earnings are never the property of the husband, . . .

In Harrison v. Schaffner, 312 U.S. 579, 580, 582 (1941), the Supreme Court stated that the rule applicable to an anticipatory assignment of income applies when the assignor is *entitled* at the time of the assignment to receive the income at a future date and is vested with such a right. In the instant case, petitioners themselves received nothing and were *never entitled* to anything. What was said in the early case of Marion Stone Burt Lansill, 17 B.T.A. 413, 423 (1929), affd. 58 F.2d 512 (C.A.D.C. 1932), seems appropriate here:

> The right in the taxpayer to receive the income at the time it is attributed and taxed to him is likewise not essential, where, as in the *Old Colony, Boston & Maine,* and *Rensselaer* and *Rosenwald* cases, supra, the taxpayer has by his own volition chosen to dispose of the right to receive income while retaining that from which the income is derived. The volition in disposing of the right is important, *for while all will agree that one who never received or had a right to receive or who has involuntarily lost it should not be taxed,* it is also plain that his voluntary exercise of the right to dispose of the income before receipt may be just as valuable and important practically as its exercise after receipt. . . . [Emphasis supplied.]

It cannot be argued that Paul voluntarily gave up *his* right to get the annuity policy and designated his daughter to receive it in his place. There was no discretion on his part; the choice was to accept the terms of the contest or reject them.

In the case before us, the taxpayer, while he had no power to *dispose* of income, had a power to appoint or designate its recipient. Does the existence or exercise of such a power alone give rise to taxable income in his hands? We think clearly not. In Nicholas A. Stavroudes, 27 T.C. 583, 590 (1956), we found it to be settled doctrine that a power to direct the distribution of trust income to others is not alone sufficient to justify the taxation of that income to the possessor of such a power. See also Bateman v. Commissioner, 127 F.2d 266 (C.A. 1, 1942).

Granted that an individual cannot escape taxation on income to which he is entitled by "turning his back" upon that income, the fact remains that he must have received the income or had a right to do so before he is taxable thereon. As stated by the court in United States v. Pierce, 137 F.2d 428, 431 (C.A. 8, 1943):

> The sum of the holdings of all cases is that for purposes of taxation income is attributable to the person entitled to receive it, although he assigns his right in advance of realization, and although, in the case of income derived from the ownership of property, he transfers the property producing the income to another as trustee or agent, in either case retaining all the practical benefits of ownership.

Section 1(a) of the 1954 Code imposes a tax on the "income of every individual." Where an individual neither receives nor has the right to receive income, he is

not the taxable individual within the contemplation of the statute. There is no basis in the statute or in the decided cases for a construction at variance with this fundamental rule.

Reviewed by the Court.

Decision will be entered for the petitioners.

DAWSON, J., concurring: Harrison v. Shaffner, 312 U.S. 579 (1941), settled the proposition that there can be no anticipatory assignment of income unless the assignor is entitled at the time of assignment to receive the income at a future date and is vested with such a right. Paul Teschner was at no time "vested with the right to receive income" under the rules of the contest and, therefore, could not possibly "escape the tax by any kind of anticipatory arrangement." Consequently, the cases cited by the dissent, Lucas v. Earl, 281 U.S. 111 (1930), Helvering v. Horst, 311 U.S. 112 (1940), and Helvering v. Eubank, 311 U.S. 122 (1940), all of which held that "one *vested with the right to receive income* [does] not escape the tax by any kind of anticipatory arrangement, however skillfully devised," Harrison v. Shaffner, supra at 582 (emphasis supplied), are inapposite here.

It is true that a taxpayer having the right to dispose of income would be taxable on the exercise of such a right where the disposition results in an economic benefit to him. However, in the instant case Paul Teschner had no *right of disposition,* but only a *duty* under the contest rules to designate a person under the age of 17 years, 1 month. Compliance with this duty was a *condition precedent* for entry of persons over that age into the contest. While it might be said concomitantly that there was a right to designate to *whom* the prize would go if it *were* won, no economic benefit could be conferred upon anyone when this right was exercised since there was no income upon which such a right of designation could operate at the time the designation was made. If those who disagree with this result fear the prize (annuity policy) will escape taxation, there is no problem because it would appear to be taxable to the daughter under the provisions of section 74, I.R.C. 1954.

MULRONEY, J., agrees with this concurring opinion.

ATKINS, J., dissenting: It is a well-settled principle of our income tax law that personal earnings are taxable to the earner, and that cases involving the taxation of personal earnings are not to be decided by attenuated subtleties. Lucas v. Earl, 281 U.S. 111, in which the Supreme Court held an anticipatory assignment of future personal earnings to be ineffective to relieve the earner of tax. . . . The annuity policy which Paul won resulted from his personal efforts. The fruit of his labor consisted of the payment of the award to his designee, his daughter. His efforts alone generated the income in question; and it is a matter of no consequence that, under the rules of the contest, such income could not be paid to him, for he had the power to control its disposition. He in fact exercised that power when he entered the contest, by designating the natural object of his bounty, his daughter, as the recipient of any prize which he might win. The exercise of such power, with resultant payment to the daughter, constituted the enjoyment and hence the realization of the income by Paul. In the circumstances he should be fully charged with the income. Cf. Helvering v. Horst, 311 U.S. 112, and Helvering v. Eubank, 311 U.S. 122. There is no more basis here for narrowing the broad scope of the holding in Lucas v. Earl than there was in the *Horst* and *Eubank* cases. The decision of the majority herein rests upon "attenuated subtleties" similar to those disapproved, first in Lucas v. Earl and then again in Burnet v. Leininger, 285 U.S. 136, Helvering v. Horst, Helvering v. Eubank, Harrison v. Schaffner, 312 U.S. 579, and Commissioner v. P. G. Lake, Inc., 356 U.S. 260.

TIETJENS, OPPER, RAUM, WITHEY, PIERCE, and SCOTT, JJ., agree with this dissent.

NOTE

Implications of Teschner. If Johnson and Johnson offered to employ the taxpayer on condition that he designate, irrevocably, a child under the age of 17 to receive his salary, would the majority come to the same conclusion? Would this depend on whether the salary could be used, or in fact was used, to discharge the taxpayer's obligation to support the person named to receive it? Would the dissenters reach the same result if Johnson and Johnson offered to pay $100,000 to the medical school whose dean submitted the best 25-word essay beginning: "A medical school education is a public service because . . ."?

With *Teschner,* see Commissioner v. Giannini, 129 F.2d 638 (9th Cir. 1942), involving the president of a corporation who was entitled to receive a percentage of business profits as compensation. During a taxable year (1927), he advised the corporation that he would not accept any more compensation for that year and "suggested that the corporation do something worth while with the money"; early the following year, the corporation contributed the amount which the taxpayer had refused ($1,500,000) to the University of California. The court held that "we cannot say as a matter of law that the money was beneficially received by the taxpayer." In Hedrick v. Commissioner, 154 F.2d 90 (2d Cir. 1946), a taxpayer who refused to cash a series of pension checks because he feared that as a pensioner he would find it difficult to obtain other employment was held taxable. The court had this to say of *Giannini:*

> Perhaps [it] may be distinguished on the facts. If, as we understand them, the amount sought to be taxed as income was offered compensation which the taxpayer refused before he performed the services for which he might have been so paid and the [employer] acquiesced in the taxpayer's insistence that he should serve for the remainder of the year without additional compensation, we agree with it. In so far as it cannot be so distinguished, we are not persuaded that it should be followed.

See Note, Disclaimers in Federal Taxation, 63 Harv. L. Rev. 1047, 1051ff (1950).

BLAIR v. COMMISSIONER

300 U.S. 5 (1937)

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

This case presents the question of liability of a beneficiary of a testamentary trust for a tax upon the income which he had assigned to his children prior to the tax years and which the trustees had paid to them accordingly.

The trust was created by the will of William Blair, a resident of Illinois who died in 1899, and was of property located in that State. One-half of the net income was to be paid to the donor's widow during her life. His son, the petitioner Edward Tyler Blair, was to receive the other one-half and, after the death of the widow, the whole of the net income during his life. In 1923, after the widow's death, petitioner assigned to his daughter, Lucy Blair Linn, an interest amounting to $6,000 for the remainder of that calendar year, and to $9,000 in each calendar year thereafter, in the net income which the petitioner was then or might thereafter be entitled to receive during his life. At about the same time, he made like assignments of interest, amounting to $9,000 in each calendar year, in the net income of the trust to his daughter Edith Blair and to his son, Edward Seymour Blair, respectively. In later years, by similar instruments, he assigned to these children additional interests, and to his son William McCormick Blair other specified interests in the net income. The trustees accepted the assignments and distributed the income directly to the assignees.

[After holding that a judgment in an earlier proceeding involving the same trust was not conclusive in this proceeding as res judicata and that the assign-

ments were valid under local law, the Supreme Court turned to the third issue in the case.]

Third. The question remains whether, treating the assignments as valid, the assignor was still taxable upon the income under the federal income tax act. That is a federal question.

Our decisions in Lucas v. Earl, 281 U.S. 111, and Burnet v. Leininger, 285 U.S. 136, are cited. In the *Lucas* Case the question was whether an attorney was taxable for the whole of his salary and fees earned by him in the tax years or only upon one-half by reason of an agreement with his wife by which his earnings were to be received and owned by them jointly. We were of the opinion that the case turned upon the construction of the taxing act. We said that "the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." That was deemed to be the meaning of the statute as to compensation for personal service and the one who earned the income was held to be subject to the tax. In Burnet v. Leininger, supra, a husband, a member of a firm, assigned future partnership income to his wife. We found that the revenue act dealt explicitly with the liability of partners as such. The wife did not become a member of the firm; the act specifically taxed the distributive share of each partner in the net income of the firm; and the husband by the fair import of the act remained taxable upon his distributive share. These cases are not in point. The tax here is not upon earnings which are taxed to the one who earns them. Nor is it a case of income attributable to a taxpayer by reason of the application of the income to the discharge of his obligation. . . . There is here no question of evasion or of giving effect to statutory provisions designed to forestall evasion; or of the taxpayer's retention of control. . . .

The Government points to the provisions of the revenue acts imposing upon the beneficiary of a trust the liability for the tax upon the income distributable to the beneficiary.* But the term is merely descriptive of the one entitled to the beneficial interest. These provisions cannot be taken to preclude valid assignments of the beneficial interest, or to affect the duty of the trustee to distribute income to the owner of the beneficial interest, whether he was such initially or becomes such by valid assignment. The one who is to receive the income as the owner of the beneficial interest is to pay the tax. If under the law governing the trust the beneficial interest is assignable, and if it has been assigned without reservation, the assignee thus becomes the beneficiary and is entitled to rights and remedies accordingly. We find nothing in the revenue acts which denies him that status.

The decision of the Circuit Court of Appeals turned upon the effect to be ascribed to the assignments. The court held that the petitioner had no interest in the corpus of the estate and could not dispose of the income until he received it. Hence it was said that "the income was *his*" and his assignment was merely a direction to pay over to others what was due to himself. The question was considered to involve "the date when the income became transferable." 83 F.(2d) at page 662. The Government refers to the terms of the assignment — that it was of the interest in the income "which the said party of the first part now is, or may hereafter be, entitled to receive during his life from the trustees." From this it is urged that the assignments "dealt only with a right to receive the income" and

* The provisions stated in general terms that the "beneficiary" of a trust was taxable on the income distributable to him. See §§652(a) and 662(a). — Ed.

that "no attempt was made to assign any equitable right, title or interest in the trust itself." This construction seems to us to be a strained one. We think it apparent that the conveyancer was not seeking to limit the assignment so as to make it anything less than a complete transfer of the specified interest of the petitioner as the life beneficiary of the trust, but that with ample caution he was using words to effect such a transfer. That the state court so construed the assignments appears from the final decree which described them as voluntary assignments of interests of the petitioner "in said trust estate," and it was in that aspect that petitioner's right to make the assignments was sustained.

The will creating the trust entitled the petitioner during his life to the net income of the property held in trust. He thus became the owner of an equitable interest in the corpus of the property. . . . By virtue of that interest he was entitled to enforce the trust, to have a breach of trust enjoined and to obtain redress in case of breach. The interest was present property alienable like any other, in the absence of a valid restraint upon alienation. . . . The beneficiary may thus transfer a part of his interest as well as the whole. See Restatement of the Law of Trusts, §§130, 132 et seq. The assignment of the beneficial interest is not the assignment of a chose in action but of the "right, title, and estate in and to property." . . . See Bogart, Trusts and Trustees, vol. 1, §183, pp. 516, 517; 17 Columbia Law Review, 269, 273, 289, 290.

We conclude that the assignments were valid, that the assignees thereby became the owners of the specified beneficial interests in the income, and that as to these interests they and not the petitioner were taxable for the tax years in question. The judgment of the Circuit Court of Appeals is reversed and the cause is remanded with direction to affirm the decision of the Board of Tax Appeals.

It is so ordered.

HELVERING v. HORST

311 U.S. 112 (1940)

MR. JUSTICE STONE delivered the opinion of the Court.

The sole question for decision is whether the gift, during the donor's taxable year, of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor.

In 1934 and 1935 respondent, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity. The Commissioner ruled that under [§61(a)], the interest payments were taxable, in the years when paid, to the respondent donor who reported his income on the cash receipts basis. . . .

The court below thought that as the consideration for the coupons had passed to the obligor, the donor had, by the gift, parted with all control over them and their payment, and for that reason the case was distinguishable from Lucas v. Earl and Burnet v. Leininger, 285 U.S. 136, where the assignment of compensation for services had preceded the rendition of the services, and where the income was held taxable to the donor.

The holder of a coupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons. Together they are an obliga-

tion to pay principal and interest given in exchange for money or property which was presumably the consideration for the obligation of the bond. Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others which constituted an economic gain to him.

Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining "realization" of income as the taxable event rather than the acquisition of the right to receive it. And "realization" is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him. . . .

In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. Cf. Aluminum Castings Co. v. Routzahn, 282 U.S. 92, 98. This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. The question here is, whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him, see Old Colony Trust Co. v. Commissioner, 279 U.S. 716; Bowers v. Kerbaugh-Empire Co., 271 U.S. 170; United States v. Kirby Lumber Co. [supra p. 89], or if he sets up a revocable trust with income payable to the objects of his bounty, Corliss v. Bowers, 281 U.S. 376, he does not escape taxation because he did not actually receive the money. . . .

Underlying the reasoning in these cases is the thought that income is "realized" by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them. Cf. Burnet v. Wells, 289 U.S. 670.

Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself he has nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money

he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named. Burnet v. Wells, supra.

In a real sense he has enjoyed compensation for money loaned or services rendered and not any the less so because it is his only reward for them. To say that one who has made a gift thus derived from interest or earnings paid to his donee has never enjoyed or realized the fruits of his investment or labor because he has assigned them instead of collecting them himself and then paying them over to the donee, is to affront common understanding and to deny the facts of common experience. Common understanding and experience are the touchstones for the interpretation of the revenue laws.

The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it. We have had no difficulty in applying that proposition where the assignment preceded the rendition of the services, Lucas v. Earl, supra; Burnet v. Leininger, supra, for it was recognized in the *Leininger* case that in such a case the rendition of the service by the assignor was the means by which the income was controlled by the donor and of making his assignment effective. But it is the assignment by which the disposition of income is controlled when the service precedes the assignment and in both cases it is the exercise of the power of disposition of the interest or compensation with the resulting payment to the donee which is the enjoyment by the donor of income derived from them.

This was emphasized in Blair v. Commissioner, 300 U.S. 5, on which respondent relies, where the distinction was taken between a gift of income derived from an obligation to pay compensation and a gift of income-producing property. In the circumstances of that case the right to income from the trust property was thought to be so identified with the equitable ownership of the property from which alone the beneficiary derived his right to receive the income and his power to command disposition of it that a gift of the income by the beneficiary became effective only as a gift of his ownership of the property producing it. Since the gift was deemed to be a gift of the property the income from it was held to be the income of the owner of the property, who was the donee, not the donor, a refinement which was unnecessary if respondent's contention here is right, but one clearly inapplicable to gifts of interest or wages. Unlike income thus derived from an obligation to pay interest or compensation, the income of the trust was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm has been given away. . . .

The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. . . . The tax laid by the 1934 Revenue Act upon income "derived from . . . wages, or compensation for personal service, of whatever kind and in whatever form paid . . . ; also from interest . . ." therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received.

It is the statute which taxes the income to the donor although paid to his donee. Lucas v. Earl, supra; Burnet v. Leininger, supra. True, in those cases the service

which created the right to income followed the assignment and it was arguable that in point of legal theory the right to the compensation vested instantaneously in the assignor when paid although he never received it; while here the right of the assignor to receive the income antedated the assignment which transferred the right and thus precluded such an instantaneous vesting. But the statute affords no basis for such "attenuated subtleties." The distinction was explicitly rejected as the basis of decision in Lucas v. Earl. It should be rejected here, for no more than in the *Earl* case can the purpose of the statute to tax the income to him who earns, or creates and enjoys it be escaped by "anticipatory arrangements . . . however skilfully devised" to prevent the income from vesting even for a second in the donor.

Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions. The owner of a negotiable bond and of the investment which it represents, if not the lender, stands in the place of the lender. When, by the gift of the coupons, he has separated his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings and in both cases the import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew. See Lucas v. Earl, supra.

Reversed.

The separate opinion of MR. JUSTICE MCREYNOLDS.

The facts were stipulated. In the opinion of the court below [107 F.2d 907], the issues are thus adequately stated:

> The petitioner owned a number of coupon bonds. The coupons represented the interest on the bonds and were payable to bearer. In 1934 he detached unmatured coupons of face value of $25,182.50 and transferred them by manual delivery to his son as a gift. The coupons matured later on in the same year, and the son collected the face amount, $25,182.50, as his own property. There was a similar transaction in 1935. The petitioner kept his books on a cash basis. He did not include any part of the moneys collected on the coupons in his income tax returns for these two years. The son included them in his returns. The Commissioner added the moneys collected on the coupons to the petitioner's taxable income and determined a tax deficiency for each year. The Board of Tax Appeals, three members dissenting, sustained the Commissioner, holding that the amounts collected on the coupons were taxable as income to the petitioner.

The decision of the Board of Tax Appeals was reversed and properly so, I think.

The unmatured coupons given to the son were independent negotiable instruments, complete in themselves. Through the gift they became at once the absolute property of the donee, free from the donor's control and in no way dependent upon ownership of the bonds. No question of actual fraud or purpose to defraud the revenue is presented. . . .

The general principles approved in Blair v. Commissioner, 300 U.S. 5, are applicable and controlling. The challenged judgment should be affirmed.

THE CHIEF JUSTICE and MR. JUSTICE ROBERTS concur in this opinion.

NOTE

1. *The basis of Horst.* Was the father taxed on the value of the coupons at the time of gift or on the full amount of the interest? What if the interest had been paid in the year after the gift? Was it crucial to the decision that the father retained the bond? If so, why? What if he had given the coupon to his son and the bond to his daughter?

In Smith's Estate v. Commissioner, 292 F.2d 478 (3d Cir. 1961), a closely-held corporation declared a dividend on April 17, 1953, to be paid on May 10th to shareholders then

of record. Dividends received by the donee of stock transferred by gift on May 9th were held taxable to the donor, on the ground that the shareholders as of April 17th acquired a "vested right" to payment of the dividend on May 10th. Relying on the *Horst* case, the court said:

> In exactly the same way [as in *Horst*] each parent here realized the economic benefit he wished to derive from his dividend rights through his gift, followed almost immediately by the corporation's payment to his child. Such dealing by a parent with his vested right to a lawfully declared dividend, is not significantly different from the gift of negotiable interest coupons in the *Horst* case.
>
> Seeking to avoid the impact of the Horst decision the petitioners point out that there the interest coupons alone were given away. But in both cases the right to the earnings in question was a vested right to receive a determined amount of fully earned gain. Such a right is distinct from the stock ownership, though derived from it. In the horticultural metaphor which has become familiar in cases of this type, "the fruit had ripened" before the gift. In these circumstances, we see no reason why the rule of the *Horst* case should not be as fully applicable to a gift of the fruit with the tree as to a gift of the fruit alone.

What if the shares had been donated in anticipation of, but before, the declaration of a dividend?

2. *Transfer of all future income.* If the taxpayer in *Horst* had detached all the interest coupons and given them to his son, but had retained the bond, would the income be taxable to him? Compare the *Blair* case, supra, with Harrison v. Schaffner, 312 U.S. 579 (1941), where the income beneficiary of a trust assigned to her children specified amounts in dollars to be paid from the income of the trust for the following year. The Court held that the assignor was taxable on these amounts:

> Taxation is a practical matter and those practical considerations which support the treatment of the disposition of one's income by way of gift as a realization of the income to the donor are the same whether the income be from a trust or from shares of stock or bonds which he owns. It is true, as respondent argues, that where the beneficiary of a trust had assigned a share of the income to another for life without retaining any form of control over the interest assigned, this Court construed the assignment as a transfer in praesenti to the donee, of a life interest in the corpus of the trust property, and held in consequence that the income thereafter paid to the donee was taxable to him and not the donor. Blair v. Commissioner, 300 U.S. 5. But we think it quite another matter to say that the beneficiary of a trust who makes a single gift of a sum of money payable out of the income of the trust does not realize income when the gift is effectuated by payment, or that he escapes the tax by attempting to clothe the transaction in the guise of a transfer of trust property rather than the transfer of income, where that is its obvious purpose and effect. We think that the gift by a beneficiary of a trust of some part of the income from the trust property for the period of a day, a month or a year involves no such substantial disposition of the trust property as to camouflage the reality that he is enjoying the benefit of the income from the trust of which he continues to be the beneficiary, quite as much as he enjoys the benefits of interest or wages which he gives away as in the *Horst* and *Eubank* cases. Even though the gift of income be in form accomplished by the temporary disposition of the donor's property which produces the income, the donor retaining every other substantial interest in it, we have not allowed the form to obscure the reality. Income which the donor gives away through the medium of a short term trust created for the benefit of the donee is nevertheless income taxable to the donor. Helvering v. Clifford [infra p. 372]; Hormel v. Helvering, 312 U.S. 552. We perceive no difference, so far as the construction and application of the Revenue Act is concerned, between a gift of income in a specified amount by the creation of a trust for a year, see Hormel v. Helvering, supra, and the assigment by the beneficiary of a trust already created of a like amount from its income for a year.
>
> Nor are we troubled by the logical difficulties of drawing the line between a gift of an equitable interest in property for life effected by a gift for life of a share of the

income of the trust and the gift of the income or a part of it for the period of a year as in this case. "Drawing the line" is a recurrent difficulty in those fields of the law where differences in degree produce ultimate differences in kind. . . . It is enough that we find in the present case that the taxpayer, in point of substance, has parted with no substantial interest in property other than the specified payments of income which, like other gifts of income, are taxable to the donor. Unless in the meantime the difficulty be resolved by statute or treasury regulation, we leave it to future judicial decisions to determine precisely where the line shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner, for all substantial and practical purposes. [312 U.S. at 583.]

See also Galt v. Commissioner, 216 F.2d 41 (7th Cir. 1954) (landlord taxed on rent despite assignment of 20-year leasehold to children, where reversion was retained).

STRAUSS v. COMMISSIONER

168 F.2d 441 (1948), cert. denied, 335 U.S. 858 (1948), rehearing denied, 335 U.S. 888 (1948)

Before AUGUSTUS N. HAND, CHASE and FRANK, Circuit Judges.

CHASE, Circuit Judge.

The inventors of a process known as "Kodachrome," which is used in the manufacture of colored film, became entitled under a licensing agreement to receive royalties from the Eastman Kodak Company. On November 1, 1930, they assigned those royalties, except certain so-called flat royalties which may now be disregarded, to Kuhn, Loeb & Company as trustee to collect and pay them to those having the right to receive them.

The taxpayer was, on December 20, 1935, one of those who had a right to receive a certain percentage of such royalties from the trustee. He had acquired that right by performing certain personal services in connection with the financing of the Kodachrome process. On December 20, 1935, the petitioner assigned all his "right, title and interest in Kodachrome, manufactured by the Eastman Kodak Company," to his wife and the trustee was duly advised that he had done so. During 1938, the trustee paid $10,209.50 to the taxpayer's wife and during 1939 $14,183.94 which would, but for the assignment to her, have been paid to the taxpayer as his share of the royalties. The wife reported such payments in the respective years they were received and paid income taxes thereon. The commissioner, holding that the assignment was of future payments to the taxpayer for personal services performed by him, included them in his gross income for the proper years and determined deficencies accordingly. The taxpayer then petitioned the Tax Court to redetermine the deficiences, alleging, among other things, that in 1935 he was "the owner of an interest in the Kodachrome process of manufacturing color film." This was admitted in the respondent's answer and the Tax Court, three judges dissenting, expunged both deficiencies on the ground that the taxpayer had assigned property to his wife who received the payments from the trustee as income from that property and not as the assigned earnings of the taxpayer from his previously rendered personal services. This issue is reviewable as one of law, since it turns upon the proper construction of [§61(a)], in the light of undisputed facts. . . .

It is of little significance that the taxpayer in his petition in the Tax Court chose to call his right to receive part of the royalties paid by the Eastman Kodak Company "an interest in the Kodachrome process" and the Commissioner accepted that definition of it in his answer. It now appears that the "interest" was only the right to receive a percentage of the royalties. And the tax consequences of the assignment of that right are, needless to say, dependent upon the real

nature of what was assigned, not upon the label attached to it by the parties.

It has been well settled since Lucas v. Earl, 281 U.S. 111, that compensation derived from personal services is taxable to the one who performs the service whether or not he actually receives the compensation or transfers the right to receive it before it is earned. . . . In Helvering v. Eubank, 311 U.S. 122, the principle was extended to cover the assignments of compensation due in the future for personal services performed in the past. We think the last mentioned case* controlling in this instance. These payments were the result of personal services performed in the past by the taxpayer. The taxpayer did not receive for those services any part of the Kodachrome process itself or any right to control the disposition of that process. Rather, he obtained the enforceable promise of the owners of the process that he would be paid for his services a definite portion of the royalties they had the right to receive from the Eastman Kodak Company. That is to say, his "interest in the process" was never greater than a contract right to be paid certain ascertainable sums of money. From first to last his pay for his services was to be only in money determinable in amount by reference to a royalty agreement covering the process. This taxpayer's right to receive royalties, we think, is indistinguishable from the right, which was considered in Helvering v. Eubank, supra, to receive part of past earned commissions on future premiums on insurance contracts. There also the assignment was of the taxpayer's right, title, and interest in the contract as well as the renewal commissions. As was said in Commissioner v. Tower, supra,

> A person may be taxed on profits earned from property, where he neither owns nor controls it. Lucas v. Earl, supra. The issue is who earned the income.

The decision on the *Kodachrome* issue is reversed with directions to reinstate the deficiency for each year.

HEIM v. FITZPATRICK

262 F.2d 887 (2d Cir. 1959)

Before SWAN and MOORE, Circuit Judges, and KAUFMAN, District Judge.

SWAN, Circuit Judge.

This litigation involves income taxes of Lewis R. Heim, for the years 1943 through 1946. On audit of the taxpayer's returns, the Commissioner of Internal Revenue determined that his taxable income in each of said years should be increased by adding thereto patent royalty payments received by his wife, his son and his daughter. . . .

Plaintiff was the inventor of a new type of rod end and spherical bearing. In September 1942 he applied for a patent thereon. On November 5, 1942 he applied for a further patent on improvements of his original invention. Thereafter on November 17, 1942 he executed a formal written assignment of his invention and of the patents which might be issued for it and for improvements thereof to The Heim Company.[1] This was duly recorded in the Patent Office and in January 1945 and May 1946 plaintiff's patent applications were acted on favorably and patents thereon were issued to the Company. The assignment to the Company was made pursuant to an oral agreement, subsequently reduced to a writing

* Helvering v. Eubank was concerned with an assignment of renewal commissions, to become payable in the future for services performed in the past, by an insurance agent who had terminated his agency contracts and services. The Court held that the case was not distinguishable from the *Horst* case and that the assignor was taxable on the commissions paid to the assignee. — ED.

[1] The stock of The Heim Company was owned as follows: plaintiff 1%, his wife 41%, his son and daughter 27% each, and his daughter-in-law and son-in-law 2% each.

dated July 29, 1943, by which it was agreed (1) that the Company need pay no royalties on bearings manufactured by it prior to July 1, 1943; (2) that after that date the Company would pay specified royalties on 12 types of bearings; (3) that on new types of bearings it would pay royalties to be agreed upon prior to their manufacture; (4) that if the royalties for any two consecutive months or for any one year should fall below stated amounts, plaintiff at his option might cancel the agreement and thereupon all rights granted by him under the agreement and under any and all assigned patents should revert to him, his heirs and assigns; and (5) that this agreement is not transferable by the Company.

In August 1943 plaintiff assigned to his wife "an undivided interest of 25 per cent in said agreement with The Heim Company dated July 29, 1943, and in all his inventions and patent rights, past and future, referred to therein and in all rights and benefits of the First Party [plaintiff] thereunder . . ." A similar assignment was given to his son and another to his daughter. Plaintiff paid gift taxes on the assignments. The Company was notified of them and thereafter it made all royalty payments accordingly. As additional types of bearings were put into production from time to time the royalties on them were fixed by agreement between the Company and the plaintiff and his three assignees. . . .

The appellant contends that the assignments to his wife and children transferred to them income-producing property and consequently the royalty payments were taxable to his donees, as held in Blair v. Commissioner, 300 U.S. 5. Judge Anderson, however, was of opinion that [151 F. Supp. 576]:

> The income-producing property, i.e the patents, had been assigned by the taxpayer to the corporation. What he had left was a right to a portion of the income which the patents produced. He had the power to dispose of and divert the stream of this income as he saw fit.

Consequently he ruled that the principles applied by the Supreme Court in Helvering v. Horst, 311 U.S. 112, and Helvering v. Eubank, 311 U.S. 122, required all the royalty payments to be treated as income of plaintiff.

The question is not free from doubt, but the court believes that the transfers in this case were gifts of income-producing property and that neither *Horst* nor *Eubank* requires the contrary view. In the *Horst* case the taxpayer detached interest coupons from negotiable bonds, which he retained, and made a gift of the coupons, shortly before their due date, to his son who collected them in the same year at maturity. Lucas v. Earl, 281 U.S. 111, which held that an assignment of unearned future income for personal services is taxable to the assignor, was extended to cover the assignment in *Horst,* the court saying at page 120, of 311 U.S.:

> Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions.

In the *Eubank* case the taxpayer assigned a contract which entitled him to receive previously earned insurance renewal commissions. In holding the income taxable to the assignor the court found that the issues were not distinguishable from those in *Horst.* No reference was made to the assignment of the underlying contract.[2]

In the present case more than a bare right to receive future royalties was assigned by plaintiff to his donees. Under the terms of his contract with The Heim

[2] These decisions were distinguished by Judge Magruder in Commissioner v. Reece, 1 Cir., 233 F.2d 30. In that case, as in the case at bar, the taxpayer assigned his patent to a corporation in return for its promise to pay royalties, and later made a gift of the royalty contract to his wife. It was held that this was a gift of income-producing property and was effective to make the royalties taxable to her. See also Nelson v. Ferguson, 3 Cir., 56 F.2d 121, certiorari denied 286 U.S. 565; Commissioner v. Hopkinson, 2 Cir., 126 F.2d 406; and 71 Harvard Law Review 378.

Company he retained the power to bargain for the fixing of royalties on new types of bearings, i.e. bearings other than the 12 products on which royalties were specified. This power was assigned and the assignees exercised it as to new products. Plaintiff also retained a reversionary interest in his invention and patents by reason of his option to cancel the agreement if certain conditions were not fulfilled. This interest was also assigned. The fact that the option was not exercised in 1945, when it could have been, is irrelevant so far as concerns the existence of the reversionary interest. We think that the rights retained by plaintiff and assigned to his wife and children were sufficiently substantial to justify the view that they were given income-producing property.

In addition to Judge Anderson's ground of decision appellee advances a further argument in support of the judgment, namely, that the plaintiff retained sufficient control over the invention and the royalties to make it reasonable to treat him as owner of that income for tax purposes. Commissioner v. Sunnen, 333 U.S. 591, is relied upon. There a patent was licensed under a royalty contract with a corporation in which the taxpayer-inventor held 89% of the stock. An assignment of the royalty contract to the taxpayer's wife was held ineffective to shift the tax, since the taxpayer retained control over the royalty payments to his wife by virtue of his control of the corporation, which could cancel the contract at any time. The argument is that, although plaintiff himself owned only 1% of The Heim Company stock, his wife and daughter together owned 68% and it is reasonable to infer from depositions introduced by the Commissioner that they would follow the plaintiff's advice. Judge Anderson did not find it necessary to pass on this contention. But we are satisfied that the record would not support a finding that plaintiff controlled the corporation whose active heads were the son and son-in-law. No inference can reasonably be drawn that the daughter would be likely to follow her father's advice rather than her husband's or brother's with respect to action by the corporation. . . .

For the foregoing reasons we hold that the judgment should be reversed and the cause remanded with directions to grant plaintiff's motion for summary judgment.

So ordered.

2. *Trusts*

In the foregoing cases the courts had to determine which of *two* parties should be taxed on the income. We now turn to situations in which *three* (or more) parties are potential taxpayers: the owner of property transfers it to a trustee* to administer, with instructions for distributing the income, currently or at a later date, to one or more beneficiaries. Who — the grantor, the trust, or one of the beneficiaries — is taxed on the income? Occasionally there is another possibility: a person who under the trust instrument can get the income or corpus on demand.

In the ordinary case, where the trust is irrevocable and the grantor reserves little or no control over it, the trust income will be taxed either to the trust or to the beneficiaries. Trusts of this character, sometimes called "pure" or "ordinary" trusts, are governed by §§641-668 of the Code. In a few cases, however, the grantor retains so much power over the economic benefits of the trust property

* On the status of a legal life tenant of property, see United States v. De Bonchamps, 278 F.2d 127 (9th Cir. 1960), Security-First National Bank v. United States, 181 F. Supp. 911 (S.D. Cal. 1960), and Rev. Rul. 61-102, 1962-1 C.B. 245, treating the life tenant as though he were the trustee of a trust of which he and the remainderman were the beneficiaries; Note, Capital Gains Taxation of a Legal Life Tenant with a Limited Power to Consume Corpus, 28 U. of Chi. L. Rev. 520 (1961).

See generally Stephens and Freeland, The Federal Tax Meaning of Estates and Trusts, 18 Tax L. Rev. 251 (1963).

that he is taxed as the "substantial owner" thereof. These trusts, sometimes called "grantor" trusts, are governed by §§671-677 of the Code. Finally, where another person has the right to get the income or corpus of the trust upon demand, he may be taxed as the substantial owner under §678. Trusts of this type are sometimes called "Mallinckrodt" trusts, after a leading case (infra p. 381n) holding that such a person was to be taxed as the substantial owner of the income. Special rules are prescribed for employee's pension and similar trusts, §501(a); for certain tax-exempt organizations in trust form, §501(c); for alimony trusts, §682; and for certain other trusts, which are not discussed here.

The statutory provisions governing "pure" or "ordinary" trusts are exceedingly complex; they have been periodically revised, most recently in 1954, and the process of legislation is clearly not yet at an end. In an effort to make the statutory scheme less formidable, the Code distinguishes between "simple" trusts (those that are required to distribute all income currently and that have made no distributions of corpus and claim no charitable deduction in the taxable year) and "complex" trusts (all others). The statutory provisions applicable to "simple" trusts are to be found in Subpart B of Subchapter J (§§651-652), those applicable to "complex" trusts in Subparts C and D of Subchapter J (§§661-668).

The basic statutory principle, applicable to both "simple" and "complex" trusts, is that the beneficiary is taxed on income that is either distributed or distributable to him,* the trust being taxed on the balance of the income. Note that §102(a), providing that gifts are not includible in the donee's gross income, does not protect the beneficiary of trust income, because of §102(b). See page 146 supra. Thus the distinction between "gifts," which can be received tax-free under §102 (a), and gifts of "income from property," which are taxable to the recipient, is delegated, so far as trust income is concerned, to the trust income rules of Subchapter J.

Because the beneficiary, rather than the trust, is taxed on amounts which are distributable by the trust, it is often said that the trust is treated as a "conduit." This is true in the main, but it should be noted that accumulated income is taxed to the trust itself not only where the ultimate distributee is unidentifiable, but also where he is known and has an indefeasible interest in the accumulated income. The conduit principle is applied in many ways, however. See, for example, §652(b) and §662(b), which provide that distributed income shall have the same character in the hands of the beneficiary as in the hands of the trust. Thus, tax-exempt and partially tax-exempt interest, dividends subject to the dividends received credit, and capital gains preserve their special character in the hands of the beneficiary. If there is more than one beneficiary, each receives his appropriate share of these items, unless they are allocated differently by local law or the trust instrument. See Regs. §1.652 (b)-1 and §1.652(b)-2; similar, but more intricate, rules are applicable under §662(b).

The taxable income of a trust, whether "simple" or "complex," is computed in about the same manner as an individual's taxable income. The principal excep-

* The beneficiary must include trust income "which is required to be distributed currently," whether actually distributed or not. §§652, 662. Under a similar provision of pre-1954 law, there was a division of opinion over the proper treatment of income that the trustee wrongfully or mistakenly refused to pay over. Compare Bedford v. Commissioner, 150 F.2d 341, 345 (2d Cir. 1945) (beneficiary taxed), with Harrison v. Commissioner, 7 T.C. 1 (1946) (not taxed until dispute settled); Moore and Sorlien, Homeless Income, 8 Tax L. Rev. 425, 443 et seq. (1953). It would now appear that the correct tax treatment may depend retroactively upon the outcome of the local dispute. Rev. Rul. 62-147, 1962-2 C.B.151; United States v. Higginson, 238 F.2d 439 (1st Cir. 1956); Polt v. Commissioner, 233 F.2d 893 (2d Cir. 1956). The Supreme Court held under pre-1954 law that the beneficiary was not taxable on amounts erroneously distributed to him by the trustee. Freuler v. Helvering, 291 U.S. 35 (1934).

tions are: (1) in lieu of the deductions allowed to the individual for himself and his dependents, a trust is allowed a deduction of either $100 or $300 per year, §642(b); (2) the optional standard deduction is not allowed to trusts, §142(b)(4); and (3) a trust's deduction for charitable contributions is not restricted to amounts actually paid during the taxable year subject to the 20-30 per cent limits of §170, but instead is allowed for any amount of gross income which, pursuant to the terms of the trust instrument, is paid or "permanently set aside" for charitable purposes, §642(c). In addition, of course, the trust may deduct distributions which under the conduit principle are taxed to the beneficiaries.

Because a trust may distribute not only current income, but also corpus and accumulated income that was previously taxed to the trust, a method must be provided for determining what part of the year's distributions is taxable to the recipients. It will be recalled that a gift is ordinarily tax-exempt under §102(a), but that §102(b) denies the exclusion if the gift is "of income from property." One method of distinguishing between taxable and tax-free distributions by trusts, based on state law, would be to tax the beneficiaries to the extent that they receive amounts constituting "income" for trust accounting, exempting all other distributions. This method, which was the guiding premise of pre-1954 law, violated the conduit principle by taxing the recipients on some amounts that were receivable tax-free by the trust; and it could also result in "wasting" tax-deductible expenses that under state law were charged to corpus in a year when the trust distributed all of its income and consequently had no use for the deductions. The 1954 Code continued the basic attempt to tax all distributions which could reasonably be deemed income, but created a new concept to distinguish between taxable and tax-free distributions — "distributable net income" — which is based on the trust's taxable income (with appropriate adjustments), rather than on income as defined by state law for trust accounting, and which preserves corpus deductions from "waste" by making them available to the beneficiaries.

Except when the "throwback" device of §§665-669 is applicable (infra p. 364), the beneficiaries in the aggregate are taxed on the lesser of (1) the amounts distributable to them by the trust, and (2) the trust's "distributable net income." Even where the second limitation applies, however, they are not necessarily taxed on the distributable net income in full. This is because it may include tax-exempt interest or other items that, though not distributed from corpus, are receivable tax-free for some other reason and which, by virtue of the conduit principle, do not lose their character by passing through the trust. For an example of the computation of distributable net income, see Regs. §1.643(c)-2.

It should be noted that distributions by the trust are taxable to the recipients (and deductible by the trust) up to the amount of the trust's "distributable net income," even if charged by the trustee against corpus rather than income. Thus, if in the taxable year the trustee exercises his discretion to accumulate all current income, but invades corpus for the benefit of the remainderman, the distribution is taxable to the remainderman up to the amount of the trust's distributable net income. The introduction of the distributable net income limitation in the 1954 Code permits the application of a broadened rule that, subject to this limitation, all distributions are deemed taxable distributions of income. There are certain exceptions, primarily for a gift of a specific sum of money or of specific property, if (pursuant to the trust instrument) it is paid or credited all at once or in not more than three installments; such a distribution is treated as a tax-free gift under the spirit of §102(a) and is not taxed to the beneficiary, or deductible by the trust, even though the trust's entire income is accumulated in that year, §663(a)(1).

If the distributions for a given year exceed the trust's "distributable net income," a method of allocating taxable income among the beneficiaries must be

found. Under §662(a), income that the trust is required to distribute currently is taxed to the beneficiaries thereof, up to the amount of the distributable net income; and if this does not exhaust the distributable net income, the balance is taxed to those who have received discretionary current income, accumulated income, or corpus, §662. (Here again, a gift of a specific sum of money or of specific property is protected against tax by §663(a)(1).) This system of allocating the distributable net income first to the beneficiaries who are entitled to receive current income (or pro rata among them if distributable net income is less than currently distributable income), with only the excess distributable net income being taxed to other beneficiaries (or pro rata among them) was instituted in 1954, and is known as the "two-tier" system. It is illustrated by the following example in §1.662(a)-3(d) of the Regulations:

> The terms of a trust require the distribution annually of $10,000 of income to A. If any income remains, it may be accumulated or distributed to B, C, and D in amounts in the trustee's discretion. He may also invade corpus for the benefit of A, B, C, or D. In the taxable year, the trust has $20,000 of income after the deduction of all expenses. Distributable net income is $20,000. The trustee distributes $10,000 of income to A. Of the remaining $10,000 of income, he distributes $3,000 each to B, C, and D, and also distributes an additional $5,000 to A. A includes $10,000 in income under section 662(a)(1). The "other amounts distributed" amount to $14,000, includible in the income of the recipients to the extent of $10,000, distributable net income less the income currently distributable to A. A will include an additional $3,571 (5,000/14,000 × $10,000) in income under this section, and B, C, and D will each include $2,143 (3,000/14,000 × $10,000).

The two-tier system of allocating distributable net income is subject to an exception, the "separate share" rule of §663(c), which is designed to correct, in certain cases, an inequity that results from the fact that under the tier system a distribution charged to corpus may be taxed as income to the recipient. Assume a trust for the grantor's three children, under which the trustee has the discretion to distribute or accumulate one third of the income for each child, together with the power to invade one third of the corpus for each child, with each child's share of accumulated income and undistributed corpus to be paid over to him at a later date. Assume also that in the taxable year the trustee distributes one third of the income to one child, together with a portion of his share of the corpus, accumulates the remaining income, and makes no other distribution of corpus. Under the two-tier system of §662(a), both the income distribution (falling in the first tier) and the distribution of corpus (falling in the second tier) would be taxable to the recipient, up to the amount of the trust's distributable net income, although two thirds of the distributable net income is being accumulated for the other two children and would — but for the fortuitous distribution to the first child — have been taxed to them, if it had been distributed, or to the trust if accumulated (with the trust's taxes probably being charged by the trustee against their shares). To avoid taxing the first child on the entire distributable net income, the separate share rule of §663(c) requires each child's one-third interest in income and corpus to be treated as a separate trust for purposes of determining "distributable net income." Thus, no more than one third of the distributable net income can be allocated to any one child, no matter how large the distribution to him. For an illustration of the separate share rule, see Regs. §1.663(c)-4. The inequity that the separate share rule is designed to correct will not arise if the trust instrument can be construed to create separate trusts under state law, infra page 365, and in this event there will also be multiple exemptions and separately computed taxes on the three trusts.

One more important innovation of the 1954 Code remains to be described. It

was stated earlier that the beneficiaries of a trust are ordinarily taxed on the lesser of (1) the amounts distributable to them and (2) the trust's "distributable net income." By itself, the latter limit might have been an easy road to tax avoidance. If a trust accumulated its income in even years and distributed both accumulated and current income in odd years, the beneficiary would not be taxed on more than the distributable net income in the odd years and the rest of the income would be taxed to the trust, despite the fact that income was flowing regularly to the beneficiary. Indeed, if the trust distributed its 1964 income on January 1, 1965, its 1965 income on December 31, 1965, and so on, the beneficiary would enjoy the same economic status (save for one day's delay every second year) as the beneficiary of a trust distributing all of its income annually — but the former beneficiary would have a substantial tax saving if the trust tax bracket was lower than his.

The 1939 Code tried to cope with this device (called a "Dean" trust, after Commissioner v. Dean, 102 F.2d 699 (10th Cir. 1939), a leading case) by treating distributions in the first 65 days of a taxable year as having been made during the preceding taxable year if they could be traced to the earlier year's income. But the 65-day rule was open to many objections, and the 1954 Code attempts to combat the "Dean" trust and similar devices by shifting the attack. Under the five-year throwback of §§665-669, distributions in excess of distributable net income (which, as stated supra page 362, are ordinarily treated as tax-free distributions of corpus) are stripped of their tax-free character if enough income was accumulated in the five prior years so that the distributions would have been taxed to the beneficiary had they been made in those years. To prevent double taxation of these amounts, the beneficiary may credit the taxes previously paid by the trust on them, as though the trust had made down payments of tax on his behalf. §668(b). In keeping with this theory, the beneficiary is regarded as having received not only the earlier year's income, but also the tax paid by the trust thereon (since, had the amounts been distributed in the earlier years, the trust would not have been taxed on them and consequently could have distributed more). §666(b) and §666(c). The Code provides, also in harmony with the concept of a belated distribution of earlier income, that the beneficiary's tax for the year of receipt shall not exceed what he would have paid had the amounts been distributed when earned. §668(a). Certain distributions are exempted from the throwback, so that they cannot be taxed beyond the amount of distributable net income, on the ground that they are not likely to occur against a background of intended tax avoidance; the principal exceptions are for income accumulated during a beneficiary's minority, distributions to meet a beneficiary's "emergency needs," and distributions on the termination of a trust if made more than nine years after the last transfer to the trust. §665(b).

For more on these complexities, see Michaelson, Income Taxation of Estates and Trusts (P.L.I. 1963); Nossaman, Trust Administration and Taxation, c. 42 (1957); Kamin, Surrey, and Warren, The Internal Revenue Code of 1954: Trusts, Estates and Beneficiaries, 54 Colum. L. Rev. 1237 (1954); Fillman, Selections from Subchapter J, 10 Tax L. Rev. 453 (1955); Burke, Selected Problems in the Taxation of Trusts and Estates, 1961 So. Calif. Tax Inst. 463; and, for background, Holland, Kennedy, Surrey, and Warren, Proposed Revision of the Federal Income Tax Treatment of Trusts and Estates — The A.L.I. Draft, 53 Colum. L. Rev. 316 (1953).

On the impact of federal tax law on fiduciary administration, see Miller and Yellon, Frontiers of Trust Law, 26 U. of Chi. L. Rev. 562 (1959).

It is occasionally necessary to determine whether a single trust instrument creates several trusts or only one, since each trust is entitled to its own $100 or

$300 deduction and to a separately calculated tax. See United States Trust Co. v. Commissioner, 296 U.S. 481 (1936); Hale v. Dominion National Bank, 186 F.2d 374 (6th Cir. 1951), cert. denied, 342 U.S. 821; McHarg v. Fitzpatrick, 210 F.2d 792 (2d Cir. 1954).

Conversely, the Internal Revenue Service may wish to consolidate the income of two or more trusts and tax the combined income to a single entity. The issue may arise, for example, if a grantor creates two (or 10 or 100) trusts, all in identical terms and for the benefit of the same beneficiary, in an effort to obtain a $100 or $300 exemption for each trust and to compute the tax on each trust's taxable income separately. Another objective of multiple trusts may be to avoid a throwback of accumulated income. Since this device is not applicable to an accumulation of $2000 or less, §665(b), the grantor may create a trust with $50,000 of corpus invested at 4 per cent, providing that income shall be accumulated in odd years and distributed in even years. Assuming $2000 of annual income, the trust would be taxed in odd years and the beneficiary in even years. The grantor might then create a second trust, identical in all respects except that it is to accumulate in even years and distribute in odd years. The beneficiary would then receive $4000 per year, but this amount would have been divided each year for tax purposes between him and a trust. Another method of avoiding the throwback builds on the fact that the throwback does not apply to distributions on the termination of a trust, provided the termination occurs more than nine years after the last transfer to the trust. The plan is for the grantor to create a trust to accumulate income for nine years and terminate in the tenth, a second trust to accumulate for ten years and distribute in the eleventh, etc. Commencing in the tenth year, the beneficiary would receive the accumulated income and corpus of one trust each year; but all of the income (except that earned in the year of distribution) would have been taxed to the terminating trust.

While tax avoidance by the use of multiple trusts is not a new threat to the revenue, it became more acute with the 1954 Code. An Advisory Group to the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee has proposed a legislative solution, pointing out:

> Legislation directed at the most obvious cases would be easy to draft, but it would be equally easy to avoid. Conversely, simple legislation with a broad enough scope to prevent easy avoidance would apply equally to numerous innocent situations.

Is new legislation necessary? See Boyce v. United States, 190 F. Supp. 950 (W.D. La. 1961), aff'd per curiam, 296 F.2d 731 (5th Cir. 1961) (90 trusts, created by identical instruments on the same day, consolidated for tax purposes); Fillman and Barnet, Recent Proposals on the Taxation of Estates and Trusts, 41 B.U.L. Rev. 35 (1961); Ervin, Multiple Accumulative Trusts and Related Problems Under the Income Tax, 29 So. Calif. L. Rev. 402 (1956); Comment, Taxation of Multiple Trusts, 24 U. of Chi. L. Rev. 156 (1956); Soter, Federal Taxation Aspects of Multiple-Accumulation Trusts, 31 U. Cinc. L. Rev. 351 (1962).

Up to now we have focused on "ordinary" or "pure" trusts, where the taxable person is either the trust or the beneficiary. Overriding this statutory scheme, however, are the rules governing the "grantor" * and "Mallinckrodt" trusts re-

* A person may be the grantor of a trust in substance though he was not the one who formally established it. For example, a husband may give property to his wife with a tacit understanding that she will create a trust. The husband will then be regarded as the grantor. Or, Smith may create a trust for the benefit of Jones' children and Jones, by prearrangement, may create a trust of equal value for the benefit of Smith's children. Each may be regarded as the creator of the other's trust. See generally Colgan and Molloy, Converse Trusts — The Rise and Fall of a Tax Avoidance Device, 3 Tax L. Rev. 271 (1948); infra page 1170.

See also State Street Trust Co. v. United States, infra page 1193, in which the grantor of a

ferred to at the outset of this section. These rules have been codified by the 1954 Code, but before 1954 the legislation in this area was sparse and the most spectacular developments were of judicial and administrative origin. When applicable, the rules we are about to consider take precedence, and neither the trust nor the beneficiary is taxed.

As background for what follows, the student should examine §§676 and 677 with care. They are derived from, but are not identical with, §§166 and 167 of the 1939 Code.

CORLISS v. BOWERS

281 U.S. 376 (1930)

MR. JUSTICE HOLMES delivered the opinion of the Court.

This is a suit to recover the amount of an income tax paid by the plaintiff, the petitioner, under the Revenue Act of 1924. The complaint was dismissed by the District Court, 30 F.(2d) 135, and the judgment was affirmed by the Circuit Court of Appeals, 34 F.(2d) 656. A writ of certiorari was granted by this Court.

The question raised by the petitioner is whether Sec. 219(g) of the Revenue Act of 1924 * can be applied constitutionally to him upon the following facts. In 1922 he transferred the fund from which arose the income in respect of which the petitioner was taxed, to trustees, in trust to pay the income to his wife for life with remainder over to their children. By the instrument creating the trust the petitioner reserved power "to modify or alter in any manner, or revoke in whole or in part, this indenture and the trusts then existing, and the estates and interests in property hereby created," etc. It is not necessary to quote more words because there can be no doubt that the petitioner fully reserved the power at any moment to abolish or change the trust at his will. The statute referred to provides that "where the grantor of a trust has, at any time during the taxable year, . . . the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." Section 219(g) with other similar provisions as to income in §219(h). There can be no doubt either that the statute purports to tax the plaintiff in this case. But the net income for 1924 was paid over to the petitioner's wife and the petitioner's argument is that however it might have been in different circumstances the income never was his and he cannot be taxed for it. The legal estate was in the trustee and the equitable interest in the wife.

But taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed — the actual benefit for which the tax is paid. If a man directed his bank to pay over income as received to a servant or friend, until further orders, no one would doubt that he could be taxed upon the amounts so paid. It is answered that in that case he would have a title, whereas here he did not. But from the point of view of taxation there would be no difference. The title would merely mean a right to stop the payment before it took place. The same right existed here although it is not called a title but is called a power. The acquisition by the wife of the income became complete only when the plaintiff failed to exercise the power that he reserved. . . . Still speaking with reference to taxation, if a man disposes of a fund in such a way that another is allowed to enjoy the income which it is in the power of the first to appro-

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trust who exercised his power to terminate it and cause the corpus to be distributed to the beneficiaries on condition that they create a new trust with the distributed property was held to be, in substance, the grantor of the new trust.

* The predecessor of §166 of the 1939 Code and §676 of the 1954 Code. — ED.

priate it does not matter whether the permission is given by assent or by failure to express dissent. The income that is subject to a man's unfettered command and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not. We consider the case too clear to need help from the local law of New York or from arguments based on the power of Congress to prevent escape from taxes or surtaxes by devices that easily might be applied to that end.

Judgment affirmed.

The CHIEF JUSTICE took no part in this case.

NOTE

1. *Power to revest "at any time."* As the case indicates, originally the income of a trust was taxed to the grantor if he had a power to revest "at any time during the taxable year." This rule could be avoided, with little loss of control, by a provision in the trust instrument allowing the grantor to revest the corpus in himself only if he had given notice of his intention to do so during the previous year; if he had not signified his intent to exercise the power before the beginning of the taxable year, it could be argued that he had no power to revest "at any time during the taxable year." For this reason, the statute was amended in 1934; the current version, §676(a), speaks of a trust "where at any time the power to revest . . . is exercisable by the grantor. . . ." The signficance of §676(b) (exception for powers not affecting beneficial enjoyment for a 10-year period) is indicated infra page 379.

2. *"Totten trusts" and similar arrangements.* In Rev. Rul. 62-148, 1962-2 C.B. 153, the Internal Revenue Service ruled that a taxpayer who deposits funds in a savings account in his own name "as trustee" for another person is taxable on the income if under local law the transaction creates only a revocable trust (a so-called "Totten trust" in New York, sometimes also called a "tentative trust" or a "savings bank trust").

JOSELOFF v. COMMISSIONER
8 T.C. 213 (1947)

HARLAN, Judge: The respondent justifies the taxation of the income of the two trusts involved herein to the settlor on two propositions:

(1) The settlor retained dominion and control over the trust property and remained in substance the owner thereof, and

(2) The trust is revocable by the settlor's wife, who does not have a substantial adverse interest in the disposition of the corpus or the income thereof.

[The court held that the settlor was not taxable on the trust income under the first of the government's two contentions.]

The second reason which respondent advances as to why the income of this trust should be taxed to the grantor is that the trust is revocable during the life of the grantor and before the beneficiary reaches the age of twenty-five by direction of the grantor's wife. The Commissioner contends that, under the trust instrument and the conditions surrounding it, the grantor's wife has no interest in the preservation of the trust adverse to that of the grantor and that therefore the corpus of the trust may be revested in the grantor, and under the provisions of [1939 Code, §166] * the income thereof is taxable to him.

It therefore becomes necessary for us to determine precisely what the interests

* Under §166(a) of the 1939 Code, part or all of the trust income was taxable to the grantor if any part of the trust corpus could be revested in him under a power vested "in any person not having a substantial adverse interest in the disposition of such part of the corpus or the income therefrom."

The same idea is conveyed by §676(a) of the 1954 Code, but with the changes in language described in the editor's note following this case. — ED.

of Lillian L. Joseloff, the wife of the grantor, are in the preservation of the trusts. Petitioner enumerates these interests as follows:

1. A legal interest, with pecuniary value, consisting of a contingent remainder in each trust.

2. A non-legal interest, with possible pecuniary value, consisting of (a) her right to receive income distributed to her by the Trustee without any duty to account therefor, (b) to receive principal advances free of supervision by the Trustee, and (c) to exercise her dominant position on the Committee of Control to procure a termination of either or both trusts.

The question of the substantial value of a remote contingent remainder such as exists in this case has frequently been decided, not only by this Court, but in other tribunals. It must be remembered that if neither of these trusts is revoked, Lillian Joseloff, in order to realize on her contingent remainder, would be required to survive both of her daughters and the issue of both of her daughters. In the first taxable year Lillian was 44 years of age, Joan 13, and Carol 11. In a case almost identical with the one at bar, Claire R. Savage, 4 T.C. 286, the Court speaks of such a contingent remainder and says:

> We fail to see any substantial adverse interest in the respective grantor's spouse . . . which would deter his or her use of the power to amend for the grantor's benefit. . . . The interest of the spouse is that of a contingent remainderman, and it will vest, if at all, only upon the termination of the trust under almost impossible circumstances. . . . In order for her to benefit from either of these trusts she would have to outlive the survivor of the two minor children and their issue, if any. To hold that such a remote possibility of receiving benefit constitutes a "substantial adverse interest" would do violence to the meaning of the word "substantial" and to the intent of Congress. . . .

If it be contended that grantor's wife could at least remove the primary estate of one of her children and her living issue by revoking one of the trusts, her reversionary interest would still be contingent on surviving one minor daughter and the issue of this daughter and it could certainly not be contended that in revoking the trust to accomplish this very doubtful advantage to herself her act would be "adverse" to the interest of the grantor. Petitioner, however, argues that the grantor's wife has other interests in the preservation of this trust beside her contingent remainder, to wit, her right to receive income from the trustee without any duty to account therefor. The trust instrument, however, provides that all money so received shall be used for the "support, maintenance and education" of the beneficiary. For the wife to obtain any economic benefit from this money it would be necessary for her to misappropriate the funds and violate the terms of the trust. It could hardly be said that it would be to her interest to preserve a trust, the very terms of which prevent her from procuring any benefit from such income.

Petitioner says that the wife also has the right "to receive principal advances free of the supervision by the trustee." Such advances are those advanced from the principal recommended by the advisory committee to the trustee, but it is to be noted that the grantor himself, as long as he is living, has a very definite check on such advances, as the trust provides: "The trustee shall be under no obligation to act without the approval of said Morris Joseloff during his life." Thus the wife, without the consent of the grantor, in spite of the recommendation of the committee, would receive nothing from the trustee from the principal of the trust. Her interest in such funds is certainly not adverse to the grantor, who is in a position to authorize or disapprove such advancements.

Petitioner further says that the wife, through her dominant position in the committee of control, could procure a termination of either or both trusts. This

contention is far from clear. The committee has no power to terminate the trusts except by distributing portions of the corpus and, as shown above, this cannot be done without the approval of the settlor of the trusts. Furthermore, all of such disbursements must be "for her [the beneficiary's] benefit." Any benefit to Lillian Joseloff would be in the nature of an embezzlement under the terms of the trust.

Offsetting these speculative adverse interests of the wife in the preservation of the trust, it is at once evident that the wife possesses some very substantial interests, from a purely selfish viewpoint, in the revocation of the trusts. The grantor of this trust in 1938 was sixty years of age. If the corpora of these trusts had been revested in her husband in 1941, when he was sixty-three years of age, his estate would have been enriched by $666,201.02. The income of one-third of this, under the laws of Connecticut, would have inured to Mrs. Joseloff for life at the death of her husband. Furthermore, and from a practical viewpoint, if Morris Joseloff really desired the revocation of these trusts at any time, it would be much to Morris Joseloff's advantage to compensate his wife if necessary for any pecuniary interest she might think she would be losing by the revocation of the trusts. Furthermore, this trust is entirely a family affair. Both the settlor and his wife have but one interest, and that is the interest of the family unit. The fact that Mrs. Joseloff would deposit in these trust estates 2,000 shares of Sycamore Corporation common stock having a value of $61,174.49 and thereby make it possible for that stock, in the case of the revocation of the trust, to vest in her husband, without even requiring any agreement other than a receipt therefor, given not to her, but to Morris, certainly is ample evidence that there is no adversity of interest between this settlor and his wife. If, in the face of adversity, the family interest required that these trusts be revoked and these trust funds revested in the head of the family for the purpose of creating a new family income, it would require a mind wholly aloof from human affairs to imagine for a minute that Mrs. Joseloff would not revoke these trusts, even though her husband, the grantor of the trusts, would not compensate her for her lost "adverse" interest. As was said in the case of Fulham v. Commissioner, 110 Fed.(2d) 916, at page 918, in judging the adversary interest of the person having the power of revocation where a family trust is involved, "realistic appraisal" is called for rather than a purely legalistic one. See also Commissioner v. Casperson, 119 Fed.(2d) 94.

The tenuous interests that Mrs. Joseloff has, if any, in the preservation of these trusts, as compared with the obvious tangible and immediate interests which she would achieve by the revocation of the trusts, in our opinion, require that her selfish interests in the trust be wholly on the side of their revocation and that those interests are not at all adverse to the interests of the settlor. It is, therefore, our opinion that the contentions of the respondent in his case should be sustained, but in view of certain other issues not mentioned herein which have been conceded by the respondent,

Decision will be entered under Rule 50.

Reviewed by the Court.

LEECH, BLACK, DISNEY, and KERN, JJ., concur only in the result.

NOTE

1. *Effect of family solidarity.* On the effect of an adverse interest vested in a member of the family, compare Laganas v. Commissioner, 281 F.2d 731, 735 (1st Cir. 1960):

> It has been said that because of "family solidarity" a wife's interest in income is not truly adverse to her husband's. Altmaier v. Commissioner, 6 Cir., 1940, 116 F.2d 162, certiorari denied 312 U.S. 706; cf. Fulham v. Commissioner, 110 F.2d 916 (1st Cir.

1940). However, such a concept often counters reality. Is the commissioner to investigate the existing rapport, or lack of it, between a particular taxpayer and his wife before determining the incidence of the tax? We believe that a single rule must be adopted, and that the preferable one is to assume that each wife stands on her own feet.

2. *The "nonadverse party" under the 1954 Code.* The 1954 Code substituted the concept of a "nonadverse party" in §§676-677 for the 1939 Code's concept of a person "not having a substantial adverse interest," and in §672(b) defined the term "nonadverse party" as any person who is not an "adverse party." *This* phrase, in turn, is defined by §672(a) as a person "having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust." The Senate Report on the 1954 Code (p. 365) implies, without being explicit, that no change of substance was intended.

Throughout the "grantor trust" provisions (§§671-678), a power vested in a nonadverse party, or in a nonadverse party jointly with the grantor, is treated the same as a power vested in the grantor alone — with a few exceptions to be noted later — and in the interest of brevity, this fact is taken for granted in the comments that follow rather than explicitly repeated.

3. *Income, estate, and gift tax consequences of an adverse interest.* Section 676 taxes the income of a trust to the grantor if a power to revest is exercisable by the grantor alone, by a nonadverse party alone, or by the grantor and a nonadverse party acting together. Under the federal estate tax, however, the corpus of a trust is includible in the grantor's gross estate if he retained until his death a right to revest, exercisable either alone or in conjunction with *any* other person. §2038(a)(1); Helvering v. City Bank Farmers Trust Co., infra page 1158. Is there any reason why the corpus of a trust should be included in the grantor's estate even if the person whose consent is required has a substantial adverse interest when the income of the trust was not taxed to the grantor during his lifetime? In another respect, the estate tax is less exacting: the corpus will not be part of the grantor's estate if the power to revest is entrusted to a third party alone, even if he does not have a substantial adverse interest. Why should such a trust insulate the grantor from estate tax but not from income tax?

The completeness of a transfer for *gift* tax purposes is governed by yet another set of rules. A transfer is subject to gift tax if the power to revest is entrusted to a third party alone, whether or not he has a substantial adverse interest. In this respect, the gift tax law resembles the estate tax law. At another point, however, the gift tax rule parallels the income tax, rather than the estate tax, rule: where the grantor retains the power to revest only with the consent of a person having a substantial adverse interest, the transfer is complete for gift tax purposes, as it is for income tax, although the trust will still be part of the grantor's estate.

See Camp v. Commissioner, infra page 1164; Advisory Committee to Treasury Department and Office of Tax Legislative Counsel, Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation with the Income Tax 9-12 (1947).

4. *Grantor's right to receive income: §677.* Section 676 is concerned with trusts under which all or any part of the corpus may be revested in the grantor. Even if he divests himself of all rights to receive the corpus, however, he is treated as the owner under §677 if the income of the trust is or may be distributed, or held or accumulated for later distribution, to him without the consent of an adverse party.

Section 677 speaks of income that is, or "may be," distributed or held for future distribution to the grantor. Does this include income that may be distributed to him only in circumstances that are unlikely to occur or that are beyond his control, or both — e.g., his extreme poverty, the death of another person, or the dissolution of a charitable institution? Under the 1939 Code, the Regulations provided that the grantor was taxable if "he has failed to divest himself, permanently and definitively, of every right which might, by any possibility, enable him to have such income, at some time, distributed to him" and that the retention of any such interest was fatal even though a distribution was conditioned "on the happening of a specified event." Regs. 118, §39.167-1(b). The cases under the 1939 Code were less strict; see Boeing v. Commissioner, 37 B.T.A. 178, 185 (1938), rev'd on other grounds, 106 F.2d 305 (9th Cir. 1939), cert. denied, 308 U.S. 619;

Evans v. Commissioner, ¶46,048 P-H Memo T.C.; but see Kaplan v. Commissioner, 66 F.2d 401 (1st Cir. 1933); Rev. Rul. 54-306, 1954-2 C.B. 240. The Regulations under the 1954 Code are somewhat less emphatic about contingent distributions than the 1939 Regulations; see Regs. §1.677(a)-1. There is a similar problem under §676 if the grantor may revest corpus in himself only on a contingency that has not occurred. See Betts v. Commissioner, 123 F.2d 534 (7th Cir. 1941); Commissioner v. O'Keefe, 118 F.2d 639 (1st Cir. 1941); and note that §676 speaks of a power which is "exercisable" by the grantor, whereas its predecessor, §166 of the 1939 Code, referred to a power "vested" in the grantor, a term that, rightly or wrongly, the courts thought was freighted with meaning.

5. *Support trusts: §677(b).* In Helvering v. Stuart, 317 U.S. 154 (1942), it was held, under the predecessor of §677(a)(1) and §677(a)(2), that the grantor was taxable on income of a trust that, in the discretion of a trustee, could be applied to the support and education of the grantor's minor children, whether it was so applied or not. The year after the *Stuart* case was decided, the predecessor of §677(b) was enacted, providing that the grantor is not taxable merely because the income may be used to support his dependents. He is taxable, however, to the extent that the income is actually so used; and §677(b) affords no protection to the grantor (a) if he retains a non-fiduciary power to apply income to the support of his dependents or (b) if the income may be applied to discharge obligations of the grantor other than maintenance and support.

In Rhode Island, a minor's parents have no obligation to provide him with a college or private school education if "there is income or principal of any trust for his or her benefit, which may be used to provide such child with an education in a college, university or private school." General Laws of Rhode Island, §33-15-1, as amended in 1958. Does this provision of local law preclude taxing a father under §677(b) if the income of a trust created by him is used to provide his minor children with a college education?

See Note, Federal Tax Aspects of the Obligation to Support, 74 Harv. L. Rev. 1191 (1961). Pedrick, Familial Obligations and Federal Taxation: A Modest Suggestion, 51 Nw. U.L. Rev. 53 (1956).

6. *Life insurance trusts: §677(a)(3).* By virtue of §677(a)(3), the grantor is taxed on the income of a trust if its income (without the consent of an adverse party) is or may be applied to pay premiums on life insurance on his life. The constitutionality of this provision was upheld in Burnet v. Wells, 289 U.S. 670 (1933). If the grantor has irrevocably assigned the policies, and has relinquished all rights to them, what is the reason for taxing him on income used to preserve or increase the value of property he no longer owns or controls?

Some difficult questions of construction arise under §677(a)(3) if the income of the trust may be applied to pay premiums but no polices are in force, if premiums are paid in violation of a trust provision forbidding such payments, if the trust instrument is silent on the use of income to pay premiums, etc. See Iversen v. Commissioner, 3 T.C. 756, 774 (1944), and cases there cited; Foster v. Commissioner, 8 T.C. 197, 205 (1947).

7. *Power to revest, or receive income from, a "portion" of trust.* The "grantor trust" provisions are invoked if the grantor may revest, or obtain the income from, a "portion" of the trust, as well as when his rights extend to the whole corpus. If the grantor has the power to recapture one half of the corpus or to demand one half of the income, the applicability of these sections is clear enough. But is §677 applicable if the grantor is entitled to the capital gains produced by the entire corpus but to none of the ordinary income — or to all of the ordinary income but none of the capital gains? See Regs. §1.677(a)-1(g), Examples (1) and (2); Berger, Taxation of Capital Gains Realized by Trusts, 12 Tax L. Rev. 99 (1956).

The grantor's power may be explicitly limited to a portion of the trust, or it may be unlimited but exercisable only with the consent of a beneficiary with an adverse interest worth less than the value of the entire trust corpus. If the corpus of a trust has a fair market value of $100,000, and the grantor's power is exercisable jointly with an independent beneficiary having an adverse interest worth $50,000, is the grantor required to report half of the trust income, or none? In answering this question, should a distinction be made between an adverse remainder interest in the whole of the corpus, and an adverse interest consisting of a right to one half the income and one half the corpus? See Regs. §1.672(a)-1.

8. *Grantor "treated as owner" of trust property.* Although the principal effect of determining that a trust is a "grantor trust" is that the grantor must report its income, §§673-677 provide more broadly that the grantor "shall be treated as the owner" of the trust property. The Regulations under §671 interpret this language to mean that the grantor, in computing his personal income tax liability, is to take into account "all items of income, deduction, and credit (including capital gains and losses) to which he would have been entitled had the trust not been in existence during the period he is treated as owner." If he is treated as owner of specific trust property or of an undivided fractional interest of the whole corpus, the items to be taken into account must be appropriately allocated. Regs. §1.671-3.

HELVERING v. CLIFFORD

309 U.S. 331 (1940)

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

In 1934 respondent declared himself trustee of certain securities which he owned. All net income from the trust was to be held for the "exclusive benefit" of respondent's wife. The trust was for a term of five years, except that it would terminate earlier on the death of either respondent or his wife. On termination of the trust the entire corpus was to go to respondent, while all "accrued or undistributed net income" and "any proceeds from the investment of such net income" was to be treated as property owned absolutely by the wife. During the continuance of the trust respondent was to pay over to his wife the whole or such part of the net income as he in his "absolute discretion" might determine. And during that period he had full power (a) to exercise all voting powers incident to the trusteed shares of stock; (b) to "sell, exchange, mortgage, or pledge" any of the securities under the declaration of trust "whether as part of the corpus or principal thereof or as investments or proceeds and any income therefrom, upon such terms and for such consideration" as respondent in his "absolute discretion may deem fitting"; (c) to invest "any cash or money in the trust estate or any income therefrom" by loans, secured or unsecured, by deposits in banks, or by purchase of securities or other personal property "without restriction" because of their "speculative character" or "rate of return" or any "laws pertaining to the investment of trust funds"; (d) to collect all income; (e) to compromise, etc., any claims held by him as trustee; (f) to hold any property in the trust estate in the names of "other persons or in my own name as an individual" except as otherwise provided. Extraordinary cash dividends, stock dividends, proceeds from the sale of unexercised subscription rights, or any enhancement, realized or not, in the value of the securities were to be treated as principal, not income. An exculpatory clause purported to protect him from all losses except those occasioned by his "own wilful and deliberate" breach of duties as trustee. And finally it was provided that neither the principal nor any future or accrued income should be liable for the debts of the wife; and that the wife could not transfer, encumber, or anticipate any interest in the trust or any income therefrom prior to actual payment thereof to her.

It was stipulated that while the "tax effects" of this trust were considered by respondent they were not the "sole consideration" involved in his decision to set it up, as by this and other gifts he intended to give "security and economic independence" to his wife and children. It was also stipulated that respondent's wife had substantial income of her own from other sources; that there was no restriction on her use of the trust income, all of which income was placed in her personal checking account, intermingled with her other funds, and expended by her on herself, her children and relatives; that the trust was not designed to relieve respondent from liability for family or household expenses and that after exe-

cution of the trust he paid large sums from his personal funds for such purposes.

Respondent paid a federal gift tax on this transfer. During the year 1934 all income from the trust was distributed to the wife who included it in her individual return for that year. The Commissioner, however, determined a deficiency in respondent's return for that year on the theory that income from the trust was taxable to him. The Board of Tax Appeals sustained that redetermination. 38 B.T.A. 1532. The Circuit Court of Appeals reversed. 8 Cir., 105 F.2d 586. We granted certiorari because of the importance to the revenue of the use of such short term trusts in the reduction of surtaxes. . . .

The broad sweep of [the language of §22(a), 1939 Code; §61(a), 1954 Code] indicates the purpose of Congress to use the full measure of its taxing power within those definable categories. . . . Hence our construction of the statute should be consonant with that purpose. Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner of the corpus. See Blair v. Commissioner, 300 U.S. 5, 12. In absence of more precise standards or guides supplied by statute or appropriate regulations, the answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation. And where the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more by devices which, though valid under state law, are not conclusive so far as [§61(a)] is concerned.

In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of [§61(a)].

So far as his dominion and control were concerned it seems clear that the trust did not effect any substantial change. In substance his control over the corpus was in all essential respects the same after the trust was created, as before. The wide powers which he retained included for all practical purposes most of the control which he as an individual would have. There were, we may assume, exceptions, such as his disability to make a gift of the corpus to others during the term of the trust and to make loans to himself. But this dilution in his control would seem to be insignificant and immaterial, since control over investment remained. If it be said that such control is the type of dominion exercised by any trustee, the answer is simple. We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. For as a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property. That might not be true if only strictly legal rights were considered. But when the benefits flowing to him indirectly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had. To exclude from the aggregate those indirect benefits would be to deprive [§61(a)] of considerable vitality and to treat as immaterial what may be highly relevant considerations in the creation of such

family trusts. For where the head of the household has income in excess of normal needs, it may well make but little difference to him (except income-tax-wise) where portions of that income are routed — so long as it stays in the family group. In those circumstances the all-important factor might be retention by him of control over the principal. With that control in his hands he would keep direct command over all that he needed to remain in substantially the same financial situation as before. Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue. Thus, where, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner of the corpus for the purposes of [§61(a)]. To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements.

The bundle of rights which he retained was so substantial that respondent cannot be heard to complain that he is the "victim of despotic power when for the purpose of taxation he is treated as owner altogether." See Du Pont v. Commissioner, 289 U.S. 685, 689.*

We should add that liability under [§61(a)] is not foreclosed by reason of the fact that Congress made specific provision in [§676] for revocable trusts, but failed to adopt the Treasury recommendation in 1934, Helvering v. Wood, 309 U.S. 344, that similar specific treatment should be accorded income from short term trusts. Such choice, while relevant to the scope of [§676], Helvering v. Wood, supra, cannot be said to have subtracted from [§61(a)] what was already there. Rather, on this evidence it must be assumed that the choice was between a generalized treatment under [§61(a)] or specific treatment under a separate provision[1] (such as was accorded revocable trusts under [§676]); not between taxing or not taxing grantors of short term trusts. In view of the broad and sweeping language of [§61(a)], a specific provision covering short term trusts might well do no more than to carve out of [§61(a)] a defined group of cases to which a rule of thumb would be applied. The failure of Congress to adopt any such rule of thumb for that type of trust must be taken to do no more than to leave to the triers of fact the initial determination of whether or not on the facts of each case the grantor remains the owner for purposes of [§61(a)].

In view of this result we need not examine the contention that the trust device

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* In this case, the Supreme Court held that the income of a number of three-year trusts, established to pay the premiums on insurance on the grantor's life, was taxable to him although he had irrevocably relinquished all rights to the policies, saying that the grantor "did not divest himself of title in any permanent or definitive way, did not strip himself of every interest in the subject-matter of the trust estate. . . . The situation in its legal effect would not be greatly different if the trusts had been created for a month or from day to day." The trusts came within the terms of what is now §677(a)(3), and the Court's attention was directed to the constitutionality of this provision, but the language of the opinion foreshadows the approach of the Court to the five-year trust in the *Clifford* case. — Ed.

[1] As to the disadvantage of a specific statutory formula over more generalized treatment see Vol. I, Report, Income Tax Codification Committee (1936), a committee appointed by the Chancellor of the Exchequer in 1927. In discussing revocable settlements the Committee stated, p. 298: "This and the three following clauses reproduce section 20 of the Finance Act, 1922, an enactment which has been the subject of much litigation, is unsatisfactory in many respects, and is plainly inadequate to fulfill the apparent intention to prevent avoidance of liability to tax by revocable dispositions of income or other devices. We think the matter one which is worthy of the attention of Parliament."

falls within the rule of Lucas v. Earl, 281 U.S. 111, and Burnet v. Leininger, 285 U.S. 136, relating to the assignment of future income; or that respondent is liable under [§676] taxing grantors on the income of revocable trusts.

The judgment of the Circuit Court of Appeals is reversed and that of the Board of Tax Appeals is affirmed.

It is so ordered.

Reversed.

MR. JUSTICE ROBERTS.

I think the judgment should be affirmed.

The decision of the court disregards the fundamental principle that legislation is not the function of the judiciary but of Congress.

In every revenue act from that of 1916 to the one now in force a distinction has been made between income of individuals and income from property held in trust. It has been the practice to define income of individuals, and, in separate sections, under the heading "Estates and Trusts," to provide that the tax imposed upon individuals shall apply to the income of estates or of any kind of property held in trust. A trust is a separate taxable entity. The trust here in question is a true trust.

While the earlier acts were in force creators of trusts reserved power to repossess the trust corpus. It became common also to establish trusts under which, at the grantor's discretion, all or part of the income might be paid to him, and to set up trusts to pay life insurance premiums upon policies on the grantor's life. The situation was analogous to that now presented. The Treasury, instead of asking this court, under the guise of construction, to amend the act, went to Congress for new legislation. Congress provided, by §219(g)(h) of the Revenue Act of 1924, that if the grantor set up such a life insurance trust, or one under which he could direct the payment of the trust income to himself, or had the power to revest the principal in himself *during any taxable year,* the income of the trust, for the taxable year, was to be treated as his.

After the adoption of these amendments taxpayers resorted to the creation of revocable trusts with a provision that more than a year's notice of revocation should be necessary to termination. Such a trust was held not to be within the terms of §219(g) of the Revenue Act of 1924, 43 Stat. 277, because not revocable within the taxable year.

Again, without seeking amendment in the guise of construction from this court, the Treasury applied to Congress, which met the situation by adopting §166 of the Revenue Act of 1934 [1954 Code, §676], which provided that, in the case of a trust under which the grantor reserved the power *at any time* to revest the corpus in himself, the income of the trust should be considered that of the grantor.

The Treasury had asked that there should also be included in that act a provision taxing to the grantor income from short term trusts. After the House Ways and Means Committee had rendered a report on the proposed bill, the Treasury, upon examination of the report, submitted a statement to the Committee containing recommendations for additional provisions; amongst others, the following:

> (6) The income from short-term trusts and trusts which are revocable by the creator at the expiration of a short period after notice by him should be made taxable to the creator of the trust.

Congress adopted an amendment to cover the one situation but did not accept the Treasury's recommendation as to the other. The statute, as before, clearly

provided that the income from a short term irrevocable trust was taxable to the trust, or the beneficiary, and not to the grantor. . . .

If some short term trusts are to be treated as non-existent for income tax purposes, it is for Congress to specify them.

MR. JUSTICE MCREYNOLDS joins in this opinion.

NOTE

1. *Aftermath of Clifford: The "Clifford Regulations."* The vagueness of the Court's criteria and the fertility of the tax advisor's imagination conspired to monopolize the time of the lower courts for years after the *Clifford* case was decided. Countless cases involving application of the *Clifford* "doctrine" to trust income were decided between 1940 and 1946.

In 1945, the Treasury issued T.D. 5488, the so-called "Clifford Regulations," which, with minor modifications, appeared as §39.22(a)-21 of Regs. 118. The Regulations, instead of relying on a judicial balancing of all the circumstances, laid down mechanical rules for determining when the grantor should be regarded as the owner in substance of the trust and hence taxable on its income. If the trust was to last for less than ten years (or, in some cases, fifteen years), *or* if the grantor had the power to determine or control the beneficial enjoyment of the income or corpus, *or* if he had administrative control over the trust that could be exercised primarily in his own interest, the income was taxable to him under the Regulations. The rules embodied in the Regulations were derived from the *Clifford* line of cases, but they did not constitute a restatement of the law; a number of individual factors were singled out and made independently responsible for imputing the income to the grantor, where the courts had ordinarily relied on the combined effect of several factors. See Alexandre, A Case Method Restatement of the New Clifford Regulations, 3 Tax. L. Rev. 189 (1947). In promulgating the new Regulations, the Treasury announced that they would be applied prospectively only. Where the new rules were more favorable to the taxpayer than the case law, however, the Service announced that it would apply them even as to pre-1946 years if no inconsistent claims were asserted by the trustees or beneficiaries. Mim. 5968, 1946-1 C.B. 25; Mim. 6156, 1947-2 C.B. 13.

For a lively debate on the Clifford Regulations, see Pavenstedt, The Treasury Legislates: The Distortion of the Clifford Rule; Eisenstein, The Clifford Regulations and the Heavenly City of Legislative Intention; with a "reply" and a "supplemental reply" by Pavenstedt, and a "postscript" by Eisenstein, all to be found in 2 Tax. L. Rev. 7, 327, 476, 569, 578 (1946-1947).

2. *Legislative endorsement of the Clifford Regulations.* In 1954, §§673-675 were enacted to supply statutory rules in this area; in doing so, Congress endorsed the main principles of the Clifford Regulations by providing that the grantor is to be treated as the owner of a trust (or of a portion thereof) if the term is sufficiently short (usually ten years) (§673), if he can control the beneficial enjoyment of income or corpus (§674), or if he has unusual powers of administration (§675). These provisions also carry over many of the details of the Clifford Regulations, although some modifications and refinements were introduced.

3. *Reversionary interests: §673.* Section 673 provides that the grantor shall be treated as the owner of a trust if he has a reversionary interest in either the corpus or the income that will or may reasonably be expected to take effect in possession or enjoyment within ten years.

There are two exceptions. One is that a reversionary interest to take effect after the death of the income beneficiary, no matter what his life expectancy, does not count against the grantor. The other exception is a reversionary interest if the income is irrevocably payable for at least two years to a single designated church, hospital, or educational institution. As §673 was originally proposed by the House Committee on Ways and Means, the income of such a trust was excluded from the grantor's gross income, and he also would have been entitled to a charitable deduction for the present value of the income when the trust was established. It was pointed out in the minority report on the bill (H.R. Rept., pp. B10-11) that:

Accordingly, the taxpayer who owns income-producing property and whose highest tax rate is greater than 50 percent can actually make money by supposedly satisfying his philanthropic desires.

For example, if the taxpayer's highest tax rate is 90 percent and he owns property producing a yearly income of $5,000, over 2 years he will have $10,000 in income, pay $9,000 in taxes, and retain $1,000 after taxes. However, if the taxpayer desires to increase his retained income from the property 800 percent, he need only make a gift of the 2-year income in trust for a charity. The charitable deduction of approximately $10,000 to which he thereby becomes entitled will reduce the taxes he would otherwise pay by $9,000. Thus, by giving up, through the charitable gift, the $1,000 which he would have retained after taxes, he will receive in exchange a $9,000 reduction in taxes. The result is an increase of $8,000 in his income after taxes (the saving in taxes of $9,000 less the net gift, after taxes, of $1,000 of income).

Similarly, a taxpayer in the 75-percent bracket will double his retained income from the property through the 2-year gift in trust; the taxpayer in the 60-percent bracket will increase his retained income by 50 percent; and the taxpayer in the 50 percent bracket will be able to make the "gift" without giving up any money.

Obviously, the only charitable impulses that are involved in this provision are those toward the upper-income taxpayer. If it becomes law such 2-year trusts will mushroom and be, in time, a severe blow to the revenue.

We are pleased that the majority have agreed to offer a floor amendment which will eliminate this loophole.

The bill was amended on the floor of the House to disallow the charitable deduction for any property transferred in trust if the grantor has a reversionary interest therein worth more than 5 per cent. §170(b)(1)(D). The concept of a 5 per cent reversionary interest is borrowed from the estate tax law, infra page 1218. Although this provision prevents the taxpayer from getting a deduction for an amount that is excluded from income, it fails to safeguard the percentage limitations of §170; a taxpayer who owns income-producing property can establish a trust for two years (or more) and thus enable a charity to receive the income without having it included in his gross income or charged against his percentage allowance. Note also that §170(b)(1)(D) bars a charitable deduction only if the 5 per cent reversionary interest is vested in the grantor, not if it is vested in his wife or children.

4. *Additions to and extensions of existing trusts.* If a grantor transfers additional property to an existing trust, the reversionary interest rule of §673 is to be applied "as of the inception of that portion of the trust." Thus, even if a grantor's reversionary interest in the trust corpus or income is outside of §673 because the trust was created for a twelve-year period, an addition to the trust in its fourth year will create a reversionary interest to take effect in possession or enjoyment in eight years, and the grantor will be treated as owner of that portion of the corpus.

If the life of an existing trust is extended, the extension has the effect of a new transfer in trust, the term of which commences on the date of the extension and terminates on the trust's new terminal date. Thus, if a twelve-year reversionary trust is extended at the end of its tenth year for a period to end five years after the originally prescribed date, the grantor is treated as creating a seven-year trust. By virtue of the second sentence of §673(d), however, he is not treated as owner of the corpus during the two remaining years of the original term. It should be noted that an extension of time may confer immunity prospectively on a trust that was embraced by §673 when created: if a five-year trust is extended at the end of its first year for a period ending six years after its original term, for example, the grantor has under §673(d) created a ten-year trust by postponing the date for reacquisition of the corpus. This will not save him from being taxed on the trust's income for its first year of existence, but thereafter he is in the clear.

5. *Power to control beneficial enjoyment: §674.* Section 674(a) lays down the general rule that the grantor is to be treated as owner of any portion of a trust if its "beneficial enjoyment" is subject to a "power of disposition," exercisable by the grantor alone, by a nonadverse party, or by the grantor and a nonadverse party acting together, without the approval or consent of any adverse party. If the grantor retains the power to add beneficiaries to those named in the trust instrument, to vary the proportions in which corpus

or income is to be paid to specified beneficiaries, or to accelerate or postpone the time when distributions are to be made, "beneficial enjoyment" of the trust is subject to a "power of disposition" within the meaning of §674(a).

The general rule of §674(a) is subject, however, to a number of important exceptions. Section 674(b) consists of a list of powers that may be vested in anyone; §674(c) permits somewhat broader powers to be vested in trustees who are not "related or subordinate parties who are subservient to the wishes of the grantor," a term that is partly defined by §672(c); and §674(d) permits still other powers to be vested in trustees other than the grantor or his spouse. The delicacy of these distinctions can be appreciated only by an examination of §674.

Section 674 is described and criticized by Westfall, Trust Grantors and Section 674: Adventures In Income Tax Avoidance, 60 Colum. L. Rev. 326, 332-333, 345 (1960). Among his comments are the following:

> Section 674, as it now stands, appears to reflect a congressional belief that property owners should be accorded a large measure of flexibility in choosing the kinds of interests they may create by transfers in trust, without loss of the income tax benefits otherwise obtainable by immediate, absolute gifts. All should not be forced to pour their assets into receptacles fashioned from a common mold, to fit their varying dispositive desires into a Procrustean bed, even though such preferences may be shaped primarily by a desire to secure a lower effective income tax rate. Accordingly a grantor is given several alternatives.
>
> The basic choice that the grantor faces is whether he wants freedom in choosing the trustee or freedom in postponing the choice (by someone other than himself) of the beneficiaries who will actually enjoy income or principal. The Code also provides an intermediate alternative for grantors who would like a measure of each variety of freedom at the same time.
>
> If the grantor decides he is more interested in latitude in selecting the trustee or trustees, he can name anyone, including himself, without adverse income tax consequences to him by reason of the trustee's powers to control beneficial enjoyment, so long as those powers are limited in the manner prescribed by section 674(b). If, on the other hand, the grantor decides that what he wants is not so much a free hand in choosing the trustee as it is to postpone the determination of who will actually benefit from his gift, he may confer upon the trustees, if they are selected within the limitations of either section 674(c) or section 674(d), the broader discretionary powers authorized in those sections. Thus, the choice is essentially between giving the trustee the grantor really prefers limited discretionary powers and giving a trustee selected from a restricted list broader discretionary powers. . . .
>
> If tax-motivated transfers in trust are to be discouraged, revision of section 674 is necessary. Repeal of sections 674(c) and 674(d) would bring realism to bear upon the legislative assumptions concerning the ability of grantors to influence "independent" and "related and subordinate" trustees and would greatly restrict the opportunities that now exist to secure income tax benefits by making a gift in trust without deciding who is to receive the income from the trust property. It would also encourage the selection of trustees upon the basis of ability to render fiduciary service, rather than because of a trustee's formal qualifications to exercise discretionary powers without causing adverse tax consequences to the grantor. In addition, if income tax benefits are to be denied for the creation of trusts unless the grantor has determined, at the time of creation, who shall receive the income, sections 674(b)(4), 674(b)(5)(A) and 674(b)(6) should also be repealed.

See also Abramowitz, Clifford Trusts and the Control of Beneficial Enjoyment, 38 N.Y.U. Law Rev. 740 (1963).

6. *Administrative powers: §675.* Section 675(1) and §675(2) provide that the grantor is to be treated as owner of the trust property if certain unusual powers (e.g., to purchase trust property for less than adequate consideration) may be exercised by the grantor, a nonadverse party, or both, without the consent of any adverse party. Moreover, §675(3) treats the grantor as owner of the trust property if he has in fact borrowed from it, unless the loan was repaid before the beginning of the taxable year or was authorized by an inde-

pendent trustee and provided for adequate interest and security. Finally, certain powers of administration (e.g., the power to vote stock of a corporation in which the holdings of the grantor and trust are significant to voting control) are fatal under §675(4) if exercisable by anyone acting in a non-fiduciary capacity, unless the consent of a person in a fiduciary capacity is required.

The grantor in the *Clifford* case would have been taxed on its income under §673, because the term of the trust was only five years, had §673 been in effect for the taxable year involved. But would §675 have afforded an alternative ground for treating the grantor as the owner of the trust property? Consider also the income tax consequences of the administrative powers vested in the trustees in State Street Trust Co. v. United States, infra page 1193.

7. *Constitutional validity of §673.* In Commissioner v. Clark, 202 F.2d 94, 99 (7th Cir 1953), the "Clifford Regulations" were held to be unconstitutional, as well as "unreasonable and arbitrary," in providing that the income of a trust to terminate in less than ten years was ipso facto taxable to the grantor:

> As noted, the regulation which decrees that the income from a trust is that of the settlor for the sole reason that its duration is for a period of less than ten years creates a conclusive or irrebuttable presumption. Such a presumption states a rule of substantive law. This is in contrast to a rebuttable presumption which only states a rule of evidence and which the opposing party is entitled to overcome by proof. . . . And the Supreme Court has held that a statute which creates a conclusive presumption under circumstances closely akin to those of the instant case contravenes the Fourteenth Amendment if enacted by state legislature and the Fifth Amendment if enacted by Congress.

The decisions upon which the court relied were Heiner v. Donnan and Schlesinger v. Wisconsin (relating to death taxes on transfers in contemplation of death, infra p. 1121) and Hoeper v. Wisconsin (relating to a state income tax under which the income of husband and wife were aggregated, supra p. 333n). Although the court in the *Clark* case said that "even Congress would be without power to create the conclusive presumption which the Treasury has done in the regulation under attack," this warning did not deter Congress from enacting §673. It is possible that the special two-year rule applicable to charitable trusts under §673(b) owes something to the *Clark* case, which involved two short-term charitable trusts, although the *Clark* trusts themselves would not have qualified under §673(b) because their income was not dedicated to a single designated charity.

For criticism of the *Clark* rationale, see Note, The Seventh Circuit v. the Clifford Regulations: "Due Process" Emancipates the Tax Avoider, 62 Yale L.J. 1236 (1953); see also Rev. Rul. 54-48, 1954-1 C.B. 24.

8. *Relationship among §673, §676, and §677.* A trust to pay the income to A for fifteen years, corpus to revert to the grantor at the end of the period, is not taxable to the grantor under §673. What if the trust is to pay the income to A for twenty years, remainder to B, with a power in the grantor to revoke after the fifteenth year — is the grantor taxable under §676? He may have been before 1954, see Regs. 118, §39.166-1(b)(1)(ii) and (iii), and Helvering v. Dunning, 118 F.2d 341 (4th Cir. 1941), cert. denied, 314 U.S. 631. But note §676(b), which entered the Code in 1954. See also the second sentence of §677(a), similarly added in 1954. Do these 1954 changes carry the implication that a power to revoke (or to receive a distribution of income) that is not explicitly excepted (e.g., a power exercisable only after nine years or only upon the occurrence of some event) is necessarily fatal to the grantor?

Could the grantor in the *Clifford* case have been taxed under §676(a) on the ground that his reversionary interest was equivalent to a power to revoke at the end of five years? In a companion case to *Clifford,* the Supreme Court held that notwithstanding the lack of any practical difference between a revocable trust and one certain to be terminated soon, there were "nice distinctions" between them in the law of estates and that Congress intended §166 of the 1939 Code (1954 Code, §676(a)) to be applied only to revocable trusts. Helvering v. Wood, 309 U.S. 344, 347 (1940).

9. *Are §§673-677 the Treasury's exclusive weapon against grantor trusts?* The argument in the *Clifford* case over whether the sections specifically requiring the income of

certain trusts to be taxed to the grantor (1939 Code, §§166, 167; 1954 Code, §§676, 677) precluded resort to the more general language of §22(a) of the 1939 Code is echoed in §671 of the 1954 Code. It provides that the grantor shall not be taxed on the income of a trust "solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as specified in this subpart." Suppose the corpus of a trust consists of cash, and the grantor supervises the use of the funds in business transactions where his personal skill is great. Could the profits be taxed to him under the general language of §61? See S. Rept., p. 365:

> The effect of this provision [§671] is to insure that taxability of *Clifford* type trusts shall be governed solely by this subpart. However, this provision does not affect the principles governing the taxability of income to a grantor or assignor other than by reason of his dominion and control over the trust. Thus, this subpart has no application in situations involving assignments of future income to the assignor, as in Lucas v. Earl (281 U.S. 111), Harrison v. Schaffner (312 U.S. 579), and Helvering v. Horst (311 U.S. 112), whether or not the assignment is to a trust; nor are the rules as to family partnerships affected by this subpart. This subpart also has no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement.

See also Commissioner v. Hogle, infra page 1023; Rev. Rul. 55-2, 1955-1 C.B. 211.

10. *Assignments of trust income by beneficiaries.* See again Harrison v. Schaffner, supra page 356. In 1955, the Internal Revenue Service ruled that it would not seek to tax the income beneficiary of a trust if he assigned the income for ten years or more, provided he did not retain any strings that would be fatal under the "Clifford Regulations" if retained by the grantor of a trust. Rev. Rul. 55-38, 1955-1 C.B. 389.

11. *References.* Westfall, Trust Grantors and Section 674: Adventures in Income Tax Avoidance, 60 Colum. L. Rev. 326 (1960); Murray, Income Taxation of Short-Term and Controlled Trusts, 1955 So. Calif. Tax Inst. 497; Yohlin, The Short-Term Trust — A Respectable Tax-Saving Device, 14 Tax L. Rev. 109 (1958); Pedrick, Grantor Powers and Estate Taxation: The Ties that Bind, 54 Nw. U. L. Rev. 527 (1959); Kirby, Current Developments in Use of Trusts in Income and Estate Planning, 1959 So. Calif. Tax Inst. 627.

For possible statutory changes in this area, see Berall, Pending Legislative Changes in the Taxation of Short-Term and Controlled Trusts, 15 Tax L. Rev. 167 (1960).

FUNK v. COMMISSIONER
185 F.2d 127 (3d Cir. 1950)

Before Biggs, Chief Judge, and Kalodner and Hastie, Circuit Judges.

Kalodner, Circuit Judge.

The only substantial issue presented on this petition to review the decision of the Tax Court is whether there is taxable to the taxpayer under [1939 Code, §22 (a); 1954 Code, §61(a)], the income of four trusts of which she was the sole trustee in the taxable years 1938 to 1941 here involved. The trusts were created by the taxpayer's husband.

The Tax Court, four judges dissenting, held that the income of the trusts, without regard to the distributions made by the taxpayer, is taxable to her. 14 T.C. 198.

The details of the creation of the trusts in controversy are set out in our prior decision in this matter, 3 Cir., 163 F.2d 796, as a result of which the cause was remanded to the Tax Court. In its decision now under review, the Tax Court has again set forth in detail its findings concerning the creation of the trusts. We shall not repeat them here. It is sufficient to state that under the terms of four trusts, which in this respect were identical, the taxpayer, as trustee, was given the authority

> . . . in her discretion to pay all or a part of the net income annually to me (her husband, the settlor), or to herself, in accordance with our respective needs, of which she shall be

the sole judge, and to accumulate and add to principal the balance of such income, if any. Any income so accumulated and added to principal by the Trustee shall become a part of the corpus of the trust and may not thereafter be distributed by the Trustee.

Upon the death of the settlor-beneficiary, the corpus of each trust was to be distributed as he should appoint, but in default thereof, contingent beneficiaries were specified. The taxpayer and her husband were at all relevant times residents of New Jersey, where the trusts were created and administered.

The Commissioner, throughout this litigation, has contended that while the taxpayer was given control over the income of the trusts as trustee, nevertheless her control was "too little fettered to be regarded as less than absolute for tax purposes." Accordingly, he seeks to tax to her all of the income of the trusts, without regard to the manner of distribution, upon the example of Mallinckrodt v. Nunan, 8 Cir., 1945, 146 F.2d 1, certiorari denied, 324 U.S. 871, and Stix v. Commissioner, 2 Cir., 1945, 152 F.2d 562.*

The Tax Court determined that the taxpayer had

absolute control over the trusts' income; that she made distributions entirely by the exercise of her own discretion; that she took whatever she wanted each year, and gave some of the rest to her husband in certain years; that what she distributed to him was determined solely by herself without any consideration of whether or not he had any need for the income; that the petitioner's (taxpayer's) husband had no need for any of the distributions which she made to him in 1939, 1940, and 1941; and that the sums which she did distribute to him were gifts." [1]

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* Mallinckrodt v. Nunan, the leading case in this area, concerned a trust established by the taxpayer's father, under which the net income was to be employed to pay off certain debts of the grantor, then to pay $10,000 per year to the taxpayer's wife, and then to be paid to the taxpayer to the extent that he should request it. Accumulated income was to be added to corpus, to go as the taxpayer should direct by will; in default of an appointment by him, the trust was to continue for the benefit of his widow and issue. There were provisions for certain other contingencies, including a power in the taxpayer to receive corpus upon his request and with the trustees' approval, but the critical fact was that the taxpayer could get the entire income (less the amount used to pay debts and the fixed amount of $10,000 payable to his wife) upon request. The court upheld the Commissioner's determination that the undistributed income was taxable to the taxpayer, even though "[i]t is a fair assumption that the grantor contemplated that petitioner would not, during his lifetime, seek to withdraw either income or principal from the trust estate unless he needed it or unless he believed that it could be used advantageously by him for the benefit of the family." The court went on:

"We agree with the majority of the Tax Court that implications which fairly may be drawn from the opinions of the Supreme Court in Corliss v. Bowers, 281 U.S. 376, Helvering v. Clifford, 309 U.S. 331, and other cases relative to the taxability of trust income to one having command over it, justify, if they do not compel, the conclusion that the undistributed net income of the trust in suit, during the years in question, was taxable to petitioner under section 22(a) [1939 Code]. This, because the power of petitioner to receive this trust income each year, upon request, can be regarded as the equivalent of ownership of the income for purposes of taxation. In Harrison v. Schaffner, 312 U.S. 579, 580, the Supreme Court approved 'the principle that the power to dispose of income is the equivalent of ownership of it and that the exercise of the power to procure its payment to another, whether to pay a debt or to make a gift, is within the reach of the statute taxing income "derived from any source whatever."' It seems to us, as it did to the majority of the Tax Court, that it is the possession of power over the disposition of trust income which is of significance in determining whether, under section 22(a), the income is taxable to the possessor of such power, and that logically it makes no difference whether the possessor is a grantor who retained the power or a beneficiary who acquired it from another. . . . Since the trust income in suit was available to petitioner upon request in each of the years involved, he had in each of those years the 'realizable' economic gain necessary to make the income taxable to him." 146 F.2d at 5. — Ed.

[1] In its statement, "Findings of Fact," the Tax Court also determined that in making distributions for the taxable years 1938 through 1941, the taxpayer, as trustee, did not make the respective distributions to herself and to her husband upon the basis of the needs of either one of them. It also found that the taxpayer's opinion was that neither she nor her husband had any

It then concluded that the evidence showed that the taxpayer, as trustee

followed to the letter the provisions in the trust instruments that she should distribute the trust income in her discretion, and that she should be the "sole judge" of how she would distribute the income.

Thus, the Tax Court agreed with the Commissioner that the quoted clause in the trust instruments gave the taxpayer such unfettered command of the income therefrom as to bring her within the bounds of the *Mallinckrodt* and *Stix* cases. It held, too, after the manner of the *Stix* case, that the taxpayer had not shown what amount of the trusts' income she would have been compelled to pay to her husband, qua beneficiary, and hence, she had not proved what amount of the income was not within her absolute control.

It is our view that the Tax Court erred. But for the purpose of disposing of the instant petition of review we need not disagree on any principle of tax law. As the Tax Court recognized, the issue here turns on the provisions in the trust instruments[2] relating to the power of the taxpayer-trustee over the income of the trusts. . . .

. . . [W]e are impelled to the conclusion that the trustee was not clothed with either the power or right to enjoy the trust income at her option; that is, unless the word "needs" be construed in such fashion as to permit it, a point which we shall shortly reach. The authorization to the trustee to act as the "sole judge" did not convey the trust income to her alone. To the contrary, only upon a determination of "needs," however that term may be defined, was she authorized to exercise her discretion in the matter of distributions. Patently, she would not be permitted to apply one definition of the word "needs" to her co-beneficiary and at the same time another more indulgent definition to herself, qua beneficiary. For it has been specificially held in New Jersey that a trustee-beneficiary cannot use his fiduciary capacity to prefer himself, and that where the trustee is a beneficiary his conduct will be scrutinized and weighed in the ultimate determination of the issue of the propriety of his exercise of discretion. Nor does it follow, when the settlor lays down a standard, here "respective needs," that the designation of the trustee as "sole judge," or even the grant to him of "absolute discretion," obviates the necessity of exercising his judgment in a sound and honest manner, or relieves him of the duty to act in good faith and with a proper motive within the reasonable boundaries of such standard. Thus, if the trustee here neglected or refused to make a sound determination of needs, or even honestly believed that there were no needs, and acted upon the extravagance of whim and caprice, made her own desires to predominate, and distributed any part of the trusts' income as a gift, then we should think such brazen abuse of her fiduciary obligations under the terms of the trusts here involved would be universally condemned. Restatement, Trusts, Section 187; 2 Scott on Trusts (1939) Section 187.

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need for any part of the income of the trusts in the taxable years because both had their own separate and independent income of substantial proportions. Finally, it found that taxpayer "took what money she wanted, if any, for her personal use, or to satisfy some desire to be extravagant, and gave her husband whatever was left, or whatever sum she wished to give him."

2 If the empowering clauses of the trusts are clear and unambiguous, it would follow that the evidence of the settlor's intent and of the trustee's conduct would not be admissible in New Jersey; Central Hanover B. & T. Co. v. Herbert, 1949, 1 N.J. 426, 429, 64 A.2d 75, 76: "The rule is that parol evidence is admissible to explain an ambiguity in a writing, or when the intent of the donor is not clear. But where the language employed has an ordinary meaning or where the meaning is plain and unambiguous on its face, there is no ground for the application of the above rule and parol or extrinsic evidence is inadmissable." [This note has been transposed. — Ed.]

Since the single question in the case sub judice turns upon the provisions of the trust instruments, the trustee's actual conduct cannot be confused with her authorized powers. The Commissioner is not now asserting, nor did the Tax Court hold, that the trustee is taxable because she treated the trust income as her own regardless of her right to do so. The very minimum of difference between this and the *Mallinckrodt, Stix* and kindred cases, at once becomes apparent. In those two cases, the taxpayers had for their own undesignated use the primary right to, and the command of, the income involved. There was no duty to relinquish except to provide for others what they might consider proper; hence, the determination that the taxpayers should have shown what they could be required to distribute. Here, the trustee had no a fortiori right to the income, nor did the absence of any "needs" on the part of either her co-beneficiary or herself confer such right upon her. What was not needed was directed by the settlor to be accumulated and added to principal, and the trustee's discretionary power to distribute conclusively terminated. She did not even have the authority to invade the principal in the event the income proved inadequate. On the basis of the decisions already cited, it seems, therefore, beyond dispute that if the taxpayer, as the Tax Court found, was of the opinion that neither she nor her husband had any needs, however she defined that term, yet made distributions to her husband and herself, she was patently acting outside the scope of the authority conferred upon her as trustee and in violation of the confidence reposed in her.

Further, we should point out, as we once did,[3] that the fact that the taxpayer's husband, as a beneficiary, might not be in a position to compel payments to himself is not determinative of his standing to compel the trustee to accumulate, or at least to prevent her arbitrary administration of the trusts, whether for her own advantage or not. In point of law, it is not alone for him to complain, for clearly the contingent beneficiaries have a position in any proceeding involving the discharge by the trustee of her fiduciary duties, and so, too, successor or substituted trustees may maintain an action to redress a breach of trust particularly if it constitutes an appropriation of trust property.

In view of the foregoing, it must be apparent that in the final analysis the primary source of difficulty in this case, as the Commissioner contends, concerns the meaning of the word "needs." The Commissioner says that the term means, and was intended by the settlor* to mean, the equivalent of "desires," and that under the trust instruments the trustee was obliged only to distribute the income as she thought "fit" or "proper." The argument is based upon the determination that the taxpayer and her husband, qua beneficiaries, were in the taxable years independently wealthy and had no "needs" in the sense of necessities of life. The intention of the settlor, in addition, is culled by the Commissioner from an exchange of letters between the settlor and his wife at the time of the creation of the trusts,† as well as from the failure of the settlor to take any action to correct

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3 163 F.2d 796, 803.

* The settlor was president of Funk & Wagnalls Company, whose New Standard Dictionary of the English Language (1945) defines "need" as follows: "*need*, n. 1. A lack of something necessary or very desirable; want; hence, destitution or deprivation, especially of the necessaries of life; indigence; poverty; as, the poor man was in great need." — Ed.

† The letters, quoted in the Tax Court's opinion, 14 T.C. 198, 205n, were as follows:

Letter of Wilfred J. Funk to Eleanor M. Funk:

"Dear Eleanor: As you know, I have to-day made you the Trustee of four trusts designated as Trusts A, B, C, and D, the property transferred to each trust consisting of 125 shares of the capital stock of Erwin Park, Inc. Under the terms of these trusts you are to have discretion annually to divide the income between us or to accumulate and add it to the principal of the trust.

"My objective in setting up the trusts in this way is to provide substantial amounts of income

his wife if in fact she were conducting herself as trustee contrary to his design and the declarations in the trusts.

The term "needs" is not, of course, one the content of which can be defined precisely. Nevertheless, we think it establishes a standard effectively distinguishing this case from, and taking it out of the rule of, the *Mallinckrodt* and *Stix* decisions. If, as the Tax Court observed, the trusts are unambiguous and specific, it can only be said of the term "needs" that it must be construed according to its ordinary meaning. While obviously it must include the essentials of life, it has been construed in New Jersey to mean that which is reasonably necessary to maintain a beneficiary's station in life. It is not indicative of an unqualified gift, nor is it dependent upon the fancy of the administrator. Thus, its use confined the trustee to limits objectively determinable, and any conduct on her part beyond those limits would be unreasonable and a breach of trust; certainly it did not countenance extravagance, whim, or caprice. And, as we have already noted, the absence of "needs," contrary to the situation of Mallinckrodt and Stix, did not result in the entitlement of the taxpayer to the trust income.

Assuming that the letters were admissible nothing in them demonstrates an intent on the part of the settlor, or even an understanding on the part of the trustee, to incorporate into the word "needs" something other than its common sense content. Indeed, the settlor's letter suggests the correctness of the result we have reached. True, he emphasizes therein the independence of the trustee from control by himself or any other person.[4] But he refers to the trustee's "discretion," states that she is to act upon the circumstances which she finds to exist at the end of each year, and declares it his intention to put her in a position where she can exercise her own judgment as to how the circumstances should be met. Thus, the settlor has conveyed, as clearly as one might wish, his intent that the trustee should investigate and judge. His letter is inconsistent with any notion that she may act arbitrarily or capriciously. And the mandate of the trusts to accumulate, without right of re-entry by the trustee, lends weight to the conclusion that the settlor's state of mind did not encompass the thought that his wife should become the practical owner of the trusts' income. Similarly, her response to his letter emphasizes her independence of decision. It accepts the responsibility of administering the trusts and expressly acknowledges a duty with respect thereto. It is not a detailed attempt to state her understanding of her obligations, but it does not deny any of the terms of the trusts. If she has not

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which you may dispose of according to the circumstances which you find to exist at the end of each year. No one can foretell with certainty what those circumstances will be, and it is my desire to put you in a position to exercise your own judgment as to how such circumstances shall be met, to the extent of the income arising from these trust funds.

"It is your legal right and duty to exercise this discretion each year as may seem best to you, and in the exercise of this discretion you are not subject to my control or to the control of any other person."

Letter from Eleanor M. Funk to Wilfred J. Funk:

"Dear Wilfred: I have read your letter of to-day with reference to the four new trusts which you are setting up, of which you have made me Trustee.

"I understand that at the end of each year I am to decide whether I will pay the income which I have received as Trustee to you or to myself or divide it between us or accumulate and add it to principal. I am to do any or all of these things in such amounts and in such proportion as I see fit.

"I understand that the effect of these trusts is to place upon me the duty of deciding how the money shall be disposed of and that in making this decision I am not subject to your control or that of any other person." — Ed.

4 Patently, the purpose of the settlor was to avoid finding himself within the doctrine of Helvering v. Clifford, 1940, 309 U.S. 331, and the Tax Court has determined him to have successfully achieved this aim: Funk v. Commissioner, ¶44,030 P-H Memo TC (1944).

acted since then within the scope of her fiduciary duties, it is not inferable from the mere failure of her husband to complain in the taxable years that she was therefore acting within the scope of those duties. We should not speculate upon the reasons for his failure to act, but, as we have pointed out, others may still do so.

We conclude, therefore, that the taxpayer was not endowed in the trust instruments with such unfettered command that the income therefrom became, for all intents and purposes, her own money. Accordingly, the decision of the Tax Court will be reversed.

NOTE

1. *The "Mallinckrodt Regulations."* As the *Funk* case indicates, the 1939 Code contained no statutory provision explicitly governing this area, and the income of the trust could be taxed to the petitioner only under the general language of §22(a) of the 1939 Code, now §61(a). When the "Clifford Regulations" were issued in 1945, however, the Treasury issued Regulations (the "Mallinckrodt Regulations") to cover this area, and they were accepted by Congress, with minor modifications, when it enacted §678(a) of the 1954 Code.

See Trust No. 3 (Brehm) v. Commissioner, 285 F.2d 102 (7th Cir. 1960) (§678 applicable even though beneficiaries who could demand corpus were minors under state disabilities).

Note how the person who can get the corpus or income of a trust is treated if he renounces, disclaims, or partially releases his power: §678(a)(2) and §678(d). When §678 overlaps §§673-677, the grantor is treated as owner, by virtue of §678(b). Section 671 (precluding resort to §61(a) in certain circumstances) is applicable to §678, as well as to §§673-677.

Does §671 preclude taxing the beneficiaries as substantial owners if, in violation of the trust instrument, they act as though they were? See Kanter v. United States, 262 F.2d 761 (9th Cir. 1959).

2. *Under which shell is the pea hidden?* In a related case, Funk v. Commissioner, ¶44,030 P-H Memo T.C. (1944), referred to in footnote 4 of the principal case, it was held that the husband was not taxable under the *Clifford* case:

> Here Mrs. Funk was not only trustee but she was an income beneficiary under all four trust instruments. When she made payments to petitioner there remained just that much less for herself. It can not be gain-said that her interest in the income was adverse to petitioner. . . . In New Jersey the courts will not substitute their judgment for that of a trustee where discretion is given the trustee, even at the behest of a beneficiary not the grantor, except upon proof that the exercise of the discretion has been in bad faith. . . . In view of the New Jersey law, it is inconceivable that this petitioner, having voluntarily placed such obviously broad discretionary powers in another and having no real need for the trust income during the taxable years, could successfully complain had the trustee elected to pay him no income.

Did the Internal Revenue Service appeal the wrong case to the Court of Appeals? Could Mr. Funk have been taxed on the income of the trust under §677(a)(1), because Mrs. Funk could have distributed it to him to satisfy his "needs," or under §674(a), because of Mrs. Funk's control over the income?

See Note, Conclusiveness of Trust Terms in Tax Litigation: Circumvention of the Clifford Rule, 60 Yale L.J. 1426 (1951).

3. *Trusts for support of a third person's children.* If the income of a trust created by A is payable to B's minor children, can B be taxed to the extent that he is relieved of his duty to support the children? Is §678 applicable? If not, can B be regarded as a "beneficiary" of the trust under §662? See Regs. §1.662(a)-4, §1.643(c)-1; Winton, Taxation of Nongrantors Under Trusts for Support of Their Dependents, 33 Taxes 804 (1955); Sayles, Tax Consequences of "Grandfather" Trusts, 1959 So. Calif. Tax Inst. 675.

REV. RUL. 56-484

1956-2 C.B. 23

In Revenue Ruling 56-86, C.B. 1956-1, 449, it was held that a transfer of securities to a minor donee pursuant to the model custodian act adopted by the State of Colorado constitutes a completed gift for Federal gift tax purposes at the time the transfer was made and that such gift qualifies for the annual gift tax exclusion authorized by §2503(b) of the Internal Revenue Code of 1954 [infra p. 1053]. The Internal Revenue Service has been requested to consider the Federal income tax consequences of such transfers.

In Colorado, as in most jurisdictions, a father, if of sufficient ability, must support, maintain, and educate his minor children without resorting to their separate estates or their income derived from property, trusts, or annuities. See Perkins v. Westcoat (1893), 3 Colo. App. 338, 33 P. 139. However, where a gift expressly provides for the support of a child, the gift may be so applied without reference to the ability of the parent to furnish such support.

Under the Colorado custodian act, the custodian is authorized to apply so much of the income from the securities as he may deem advisable for the support of the minor, in his absolute discretion without court order, and without regard to the duty of any person to support the minor and without regard to any other funds which may be applicable or available for the purpose. The existence of this provision specifically permitting the use of the income for the support of the donee regardless of the surrounding circumstances distinguishes the instant case from the ordinary case where securities or other property are given to a minor. Compare Revenue Ruling 55-469, C.B. 1955-2, 519, which holds that dividends received by minors on stock which had been given them by their grandparents and placed in a separate bank account under the names of the parents as "trustees" are taxable to the grandchildren as beneficial owners thereof. . . .

As was indicated in the case of Miller [v. Commissioner, 2 T.C. 285 (1943)], it is assumed in these latter cases that income from the property which is the subject of the gift is the income of the child and that his father, therefore, holding the property in a fiduciary capacity as legal guardian, or otherwise, would not legally be permitted the use of any of these funds to satisfy his obligation to support the child. The same point is made in the case of Herberts [v. Commissioner, 10 T.C. 1053 (1948)], holding taxpayer's minor children taxable on income from stock which they had received as outright gifts (at page 1063), but holding their father taxable on income from a gift in trust to the extent used for the support and maintenance of the minor beneficiary for the reason that a power to make payments for the minor's support was expressly granted to the trustee at the time of the gift (at page 1070). Where a trustee is not given such power, he is not ordinarily permitted under state law to apply the income from the minor's trust for the support of the minor. Such a provision in a trust or in a statute, however, qualifies the property interest transferred to the minor under such trust or statute so as to permit the use of all or a part of the income therefrom to be diverted to another. . . .

In view of the foregoing, it is held that, regardless of the relationship of the donor or of the custodian to the donee, income derived from property transferred under the model custodian act adopted by the State of Colorado and a number of other states which is used in the discharge or satisfaction, in whole or in part, of a legal obligation of any person to support or maintain a minor is, to the extent so used, taxable to such person under section 61 of the Internal Revenue Code of 1954. However, the amount of such income includible in the gross income of a

person obligated to support or maintain a minor is limited by the extent of his legal obligations under local law. To the extent that income derived from the property in question is not so includible in the gross income of the person obligated to support or maintain the minor (donee), such income is taxable to the minor.

NOTE

1. *Status of "custodian."* Is the legal device created by this act a "trust"? If so, why does the ruling rely upon §61(a) rather than on the trust provisions of the Code? If not, would the result be different if the donor used a trust? If the minor's father is the custodian, could the income be taxed to him whether used for the child's support or accumulated? What if the father were the donor?

In Rev. Rul. 59-357, 1959-2 C.B. 212, the Internal Revenue Service ruled that the same principles are to be applied to transfers under the Uniform Gifts to Minors Act, notwithstanding minor variations between this act and the Model Gifts of Securities to Minors Act (similar to the Colorado statute discussed in the ruling above).

In Rev. Rul. 58-65, 1958-1 C.B. 13, the Service ruled that the trust provisions are not controlling when a savings account (in a savings and loan association) for a minor child is placed in the name of the parents as trustees, pursuant to an established practice, if the trustees are not subject to court order or other agreement and no trust is intended. If under local law the account belongs to the child and cannot legally be used to discharge the parents' obligation to support him, the earnings are taxable to the child as beneficial owner. The ruling cites Rev. Rul. 56-484 as authority.

2. *Reference.* Note, Recent Legislation to Facilitate Gifts of Securities to Minors, 69 Harv. L. Rev. 1476 (1956).

3. *Family Partnerships*

Section 704(e), relating to family partnerships, carries forward §191 and §3797(a)(2) of the 1939 Code.

Unlike the trust, the partnership is not a separate taxable entity. A partnership return must be filed for the Treasury's information, reporting all partnership income and deductions, but the firm's net income is taxed to the partners individually, whether withdrawn or not, in accordance with their respective interests. §§701-704. Losses of the firm are similarly allocated among the partners and deducted by them on their individual returns. The 1954 Code allows certain partnerships to be taxed, if they so elect, as corporations. See page 612 infra.

With the decline of the trust as a tax avoidance device came, fortuitously or not, the rise of the "family partnership" as a means of splitting income. Typically, the head of the family, doing business as an individual proprietor, would create a partnership by transferring by gift portions of his business capital to his wife and children, and by agreeing that thereafter the income of the enterprise would be distributed among the partners in an agreed proportion, usually according to their interests in the firm's capital. Ordinarily the new partners took no part in the management of the firm, though occasionally they served in clerical or other minor capacities. Sometimes the donor would reserve a "salary" for his own services, to be deducted before the profits accruing to capital were calculated. The high-water mark in this area is Tinkoff v. Commissioner, 120 F.2d 564 (7th Cir. 1941), involving an accountant who took his son into his accounting firm as a partner on the day the boy was born.

The Supreme Court's first direct sally into this field was in 1946, when Commissioner v. Tower, 327 U.S. 280, and Lusthaus v. Commissioner, 327 U.S. 293, were

decided. Although the lower courts could easily discern which way the wind was blowing, they were unsure of its velocity. The Supreme Court then tried again.

COMMISSIONER v. CULBERTSON

337 U.S. 733 (1949)

MR. CHIEF JUSTICE VINSON delivered the opinion of the Court.

This case requires our further consideration of the family partnership problem. The Commissioner of Internal Revenue ruled that the entire income from a partnership allegedly entered into by respondent and his four sons must be taxed to respondent, and the Tax Court sustained that determination. The Court of Appeals for the Fifth Circuit reversed. We granted certiorari to consider the Commissioner's claim that the principles of Commissioner v. Tower, 1946, 327 U.S. 280, and Lusthaus v. Commissioner, 1946, 327 U.S. 293, have been departed from in this and other courts of appeals decisions.

Respondent taxpayer is a rancher. From 1915 until October 1939, he had operated a cattle business in partnership with R. S. Coon. Coon, who had numerous business interests in the Southwest and had largely financed the partnership, was 79 years old in 1939 and desired to dissolve the partnership because of ill health. To that end, the bulk of the partnership herd was sold until, in October of that year, only about 1,500 head remained. These cattle were all registered Herefords, the brood or foundation herd. Culbertson wished to keep these cattle and approached Coon with an offer of $65 a head. Coon agreed to sell at that price, but only upon condition that Culbertson would sell an undivided one-half interest in the herd to his four sons at the same price. His reasons for imposing this condition were his intense interest in maintaining the Hereford strain which he and Culbertson had developed, his conviction that Culbertson was too old to carry on the work alone, and his personal interest in the Culbertson boys. Culbertson's sons were enthusiastic about the proposition, so respondent thereupon bought the remaining cattle from the Coon and Culbertson partnership for $99,440. Two days later Culbertson sold an undivided one-half interest to the four boys, and the following day they gave their father a note for $49,720 at 4 per cent interest due one year from date. Several months later a new note for $57,674 was executed by the boys to replace the earlier note. The increase in amount covered the purchase by Culbertson and his sons of other properties formerly owned by Coon and Culbertson. This note was paid by the boys in the following manner:

Credit for overcharge	$ 5,930
Gifts from respondent	21,744
One-half of a loan procured by Culbertson & Sons partnership	30,000

The loan was repaid from the proceeds from operation of the ranch.

The partnership agreement between taxpayer and his sons was oral. The local paper announced the dissolution of the Coon and Culbertson partnership and the continuation of the business by respondent and his boys under the name of Culbertson & Sons. A bank account was opened in this name, upon which taxpayer, his four sons and a bookkeeper could check. At the time of formation of the new partnership, Culbertson's oldest son was 24 years old, married, and living on the ranch, of which he had for two years been foreman under the Coon and Culbertson partnership. He was a college graduate and received $100 a month plus board and lodging for himself and his wife both before and after formation of Culbertson & Sons and until entering the Army. The second son was 22 years old,

was married and finished college in 1940, the first year during which the new partnership operated. He went directly into the Army following graduation and rendered no services to the partnership. The two younger sons who were 18 and 16 years old respectively in 1940, went to school during the winter and worked on the ranch during the summer.

The tax years here involved are 1940 and 1941. A partnership return was filed for both years indicating a division of income approximating the capital attributed to each partner. It is the disallowance of this division of the income from the ranch that brings this case into the courts.

First. The Tax Court read our decisions in Commissioner v. Tower, supra, and Lusthaus v. Commissioner, supra, as setting out two essential tests of partnership for income-tax purposes: that each partner contribute to the partnership either vital services or capital originating with him. Its decision was based upon a finding that none of respondent's sons had satisfied those requirements during the tax years in question. Sanction for the use of these "tests" of partnership is sought in this paragraph from our opinion in the *Tower* case:

> There can be no question that a wife and a husband may, under certain circumstances, become partners for tax, as for other, purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things she may be a partner as contemplated by [§701]. The Tax Court has recognized that under such circumstances the income belongs to the wife. A wife may become a general or a limited partner with her husband. But when she does not share in the management and control of the business, contributes no vital additional service, and where the husband purports in some way to have given her a partnership interest, the Tax Court may properly take these circumstances into consideration in determining whether the partnership is real within the meaning of the federal revenue laws. (327 U.S. at page 290).

It is the Commissioner's contention that the Tax Court's decision can and should be reinstated upon the mere reaffirmation of the quoted paragraph.

The Court of Appeals, on the other hand, was of the opinion that a family partnership entered into without thought of tax avoidance should be given recognition taxwise whether or not it was intended that some of the partners contribute either capital or services during the tax year and whether or not they actually made such contributions, since it was formed "with the full expectation and purpose that the boys would, in the future, contribute their time and services to the partnership." We must consider, therefore, whether an intention to contribute capital or services sometime in the future is sufficient to satisfy ordinary concepts of partnership, as required by the *Tower* case. The sections of the Internal Revenue Code involved are [§§701 and 702], which set out the method of taxing partnership income, and [§§1 and 61(a)], which relate to the taxation of individual incomes.*

In the *Tower* case we held that despite the claimed partnership, the evidence fully justified the Tax Court's holding that the husband, through his ownership of the capital and his management of the business, actually created the right to receive and enjoy the benefit of the income and was thus taxable upon that entire income under [§§1 and 61(a)]. In such case, other members of the partnership cannot be considered "Individuals carrying on business in partnership" and thus "liable for income tax . . . in their individual capacity" within the meaning of [§701]. If it is conceded that some of the partners contributed neither capital nor services to the partnership during the tax years in question, as the Court of Ap-

* Section 191 of the 1939 Code (§704(e) of the 1954 Code), relating specifically to family partnerships, was not enacted until 1951. — Ed.

peals was apparently willing to do in the present case, it can hardly be contended that they are in any way responsible for the production of income during those years.[1] The partnership sections of the Code are, of course, geared to the sections relating to taxation of individual income, since no tax is imposed upon partnership income as such. To hold that "Individuals carrying on business in partnership" include persons who contribute nothing during the tax period would violate the first principle of income taxation: that income must be taxed to him who earns it. Lucas v. Earl, 1930, 281 U.S. 111; Helvering v. Clifford, 1940, 309 U.S. 331; National Carbide Corp. v. Commissioner, 1949, 336 U.S. 422.

Furthermore, our decision in Commissioner v. Tower, supra, clearly indicates the importance of participation in the business by the partners during the tax year. We there said that a partnership is created "when persons join together their money, goods, labor, or skill for the purpose of carrying on a trade, profession, or business and when there is community of interest in the profits and losses." This is, after all, but the application of an often iterated definition of income — the gain derived from capital, from labor, or from both combined — to a particular form of business organization. A partnership is, in other words, an organization for the production of income to which each partner contributes one or both of the ingredients of income — capital or services. Ward v. Thompson, 1859, 22 How. 330, 334. The intent to provide money, goods, labor, or skill sometime in the future cannot meet the demands of [§§1 and 61(a)] of the Code that he who presently earns the income through his own labor and skill and the utilization of his own capital be taxed therefor. The vagaries of human experience preclude reliance upon even good faith intent as to future conduct as a basis for the present taxation of income.

Second. We turn next to a consideration of the Tax Court's approach to the family partnership problem. It treated as essential to membership in a family partnership for tax purposes the contribution of either "vital services" or "original capital." Use of these "tests" of partnership indicates, at best, an error in emphasis. It ignores what we said is the ultimate question for decision, namely, "whether the partnership is real within the meaning of the federal revenue laws" and makes decisive what we described as "circumstances [to be taken] into consideration" in making that determination.

The *Tower* case thus provides no support for such an approach. We there said that the question whether the family partnership is real for income-tax purposes depends upon

> whether the partners really and truly intended to join together for the purpose of carrying on the business and sharing in the profits and losses or both. And their intention in this respect is a question of fact, to be determined from testimony disclosed by their "agreement, considered as a whole, and by their conduct in execution of its provisions." Drennen v. London Assurance Co., 113 U.S. 51, 56; Cox v. Hickman, 8 H.L. Cas. 268. We see no reason why this general rule should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes. (327 U.S. at page 287).

The question is not whether the services or capital contributed by a partner are of sufficient importance to meet some objective standard supposedly established by the *Tower* case, but whether, considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective

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1 Of course one who has been a bona fide partner does not lose that status when he is called into military or government service, and the Commissioner has not so contended. On the other hand, one hardly becomes a partner in the conventional sense merely because he might have done so had he not been called.

abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. There is nothing new or particularly difficult about such a test. Triers of fact are constantly called upon to determine the intent with which a person acted.[2] . . .

But the Tax Court did not view the question as one concerning the bona fide intent of the parties to join together as partners. Not once in its opinion is there even an oblique reference to any lack of intent on the part of respondent and his sons to combine their capital and services "for the purpose of carrying on the business." Instead the court, focusing entirely upon concepts of "vital services" and "original capital," simply decided that the alleged partners had not satisfied those tests when the facts were compared with those in the *Tower* case. The court's opinion is replete with such statements as

> we discern nothing constituting what we think is a requisite contribution to a real partnership. . . . We find no son adding "vital additional service" which would take the place of capital contributed because of formation of a partnership . . . it is clear that the sons made no capital contribution within the meaning of the *Tower* case.

Unquestionably a court's determination that the services contributed by a partner are not "vital" and that he has not participated in "management and control of the business" or contributed "original capital" has the effect of placing a heavy burden on the taxpayer to show the bona fide intent of the parties to join together as partners. But such a determination is not conclusive, and that is the vice in the "tests" adopted by the Tax Court. It assumes that there is no room for an honest difference of opinion as to whether the services or capital furnished by the alleged partner are of sufficient importance to justify his inclusion in the partnership. If, upon a consideration of all the facts, it is found that the partners joined together in good faith to conduct a business, having agreed that the services or capital to be contributed presently by each is of such value to the partnership that the contributor should participate in the distribution of profits, that is sufficient. The *Tower* case did not purport to authorize the Tax Court to substitute its judgment for that of the parties; it simply furnished some guides to the determination of their true intent. Even though it was admitted in the *Tower* case that the wife contributed no original capital, management of the business, or other vital services, this Court did not say as a matter of law that there was no valid partnership. We said, instead, that "There was, thus, more than ample evidence to support the Tax Court's finding that no genuine union for partnership purposes *was ever intended*, and that the husband earned the income." 327 U.S. at page 292. (Italics added.)

Third. The Tax Court's isolation of "original capital" as an essential of membership in a family partnership also indicates an erroneous reading of the *Tower* opinion. We did not say that the donee of an intra-family gift could never become a partner through investment of the capital in the family partnership, any more than we said that all family trusts are invalid for tax purposes in Helvering v. Clifford, supra. The facts may indicate, on the contrary, that the amount thus contributed and the income therefrom should be considered the property of the donee for tax, as well as general law, purposes. In the *Tower* and *Lusthaus* cases this Court, applying the principles of Lucas v. Earl, supra; Helvering v. Clifford,

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[2] Nearly three-quarters of a century ago, Bowen, L. J., made the classic statement that "the state of a man's mind is as much a fact as the state of his digestion." Edgington v. Fitzmaurice, 29 L.R. Ch. Div. 459, 483. State of mind has always been determinative of the question whether a partnership has been formed as between the parties. . . .

supra; and Helvering v. Horst, 311 U.S. 112, found that the purported gift, whether or not technically complete, had made no substantial change in the economic relation of members of the family to the income. In each case the husband continued to manage and control the business as before, and income from the property given to the wife and invested by her in the partnership continued to be used in the business or expended for family purposes. We characterized the results of the transactions entered into between husband and wife as "a mere paper reallocation among the family members," noting that "The actualities of their relation to the income did not change." This, we thought, provided ample grounds for the finding that no true partnership was intended; that the husband was still the true earner of the income.

But application of the *Clifford-Horst* principle does not follow automatically upon a gift to a member of one's family, followed by its investment in the family partnership. If it did, it would be necessary to define "family" and to set precise limits of membership therein. We have not done so for the obvious reason that existence of the family relationship does not create a status which itself determines tax questions, but is simply a warning that things may not be what they seem. It is frequently stated that transactions between members of a family will be carefully scrutinized. But more particularly, the family relationship often makes it possible for one to shift tax incidence by surface changes of ownership without disturbing in the least his dominion and control over the subject of the gift or the purposes for which the income from the property is used. He is able, in other words, to retain "the substance of full enjoyment of all the rights which previously he had in the property." Helvering v. Clifford, supra, 309 U.S. at page 336.

The fact that transfers to members of the family group may be mere camouflage does not, however, mean that they invariably are. The *Tower* case recognized that one's participation in control and management of the business is a circumstance indicating an intent to be a bona fide partner despite the fact that the capital contributed originated elsewhere in the family. If the donee of property who then invests it in the family partnership exercises dominion and control over that property — and through that control influences the conduct of the partnership and the disposition of its income — he may well be a true partner. Whether he is free to, and does, enjoy the fruits of the partnership is strongly indicative of the reality of his participation in the enterprise. In the *Tower* and *Lusthaus* cases we distinguished between active participation in the affairs of the business by a donee of a share in the partnership on the one hand, and his passive acquiescence to the will of the donor on the other. This distinction is of obvious importance to a determination of the true intent of the parties. It is meaningless if "original capital" is an essential test of membership in a family partnership.

The cause must therefore be remanded to the Tax Court for a decision as to which, if any, of respondent's sons were partners with him in the operation of the ranch during 1940 and 1941. As to which of them, in other words, was there a bona fide intent that they be partners in the conduct of the cattle business, either because of services to be performed during those years, or because of contributions of capital of which they were the true owners, as we have defined that term in the *Clifford, Horst,* and *Tower* cases? No question as to the allocation of income between capital and services is presented in this case, and we intimate no opinion on that subject.

The decision of the Court of Appeals is reversed with directions to remand the cause to the Tax Court for further proceedings in conformity with this opinion.

Reversed and remanded.

MR. JUSTICE BLACK and MR. JUSTICE RUTLEDGE think that the Tax Court prop-

erly applied the principles of the *Tower* and *Lusthaus* decisions in this case. However, they consider it of paramount importance in this case to have a court interpretation of the applicable taxing statute, for guidance in its application. Accordingly, they acquiesce in the Court's opinion and judgment.

MR. JUSTICE BURTON, concurring, states that, upon remand of the cause to the Tax Court, there is nothing in the facts which have been presented here which, as a matter of law, will preclude that court from finding that the 1940 and 1941 income was properly taxable on a partnership basis. The physical absence of some of the Culbertson boys from the ranch does not necessarily preclude them or others from the obligations or the benefits of the partnership for tax purposes. Their contributions of capital, their participation in the income and their commitments to return to the ranch or otherwise to render service to the partnership are among the material factors to be considered. A present commitment to render future services to a partnership is in itself a material consideration to be weighed with all other material considerations for the purposes of taxation as well as for other partnership purposes.

MR. JUSTICE JACKSON would affirm on the opinion of the court below, being of the view that the ordinary common-law tests of validity of partnerships are the tests for tax purposes and that they were met in this case.

MR. JUSTICE FRANKFURTER, concurring.

. . . The Tax Court's decision rested on a misconception of our decision in Commissioner v. Tower. It is, however, fair to say that it was led into that misconception by phrases which it culled from the *Tower* opinion with inadequate attention to the opinion in its entirety — both what it said and what it significantly did not say. . . .

A fair reading of our *Tower* opinion in its entirety reflects the formulation of the concept of partnership which is set forth at the beginning of its analysis and which the Court now quotes. While recognizing the importance of the question "who actually owned a share of the capital attributed to the wife on the partnership books," the *Tower* opinion states the ultimate issue to be "whether this husband and wife really intended to carry on business as a partnership." To that determination it was of course relevant that no new capital was brought into the business as a result of the formation of the partnership, that the wife drew on income of the partnership only to pay for the type of things she had previously bought for the family, and that the consequence was a mere paper reallocation of income. But these circumstances were not cited as giving the term "partnership" a content peculiar to the Internal Revenue Code. They were characterized, rather, simply as "more than ample evidence to support the Tax Court's finding that no genuine union for partnership business purposes was ever intended" and, as a corollary, "that the husband earned the income."

Recognition of the importance, in applying [§§701 and 702], of the appraisal of facts makes manifest why, quite apart from the definition contained in [§7701], a determination by a State court should not, as the *Tower* opinion pointed out, foreclose a contrary determination by a federal tribunal charged with administration of the tax laws. Such an inconsistency would not mean that the legal standards applied by each were inconsistent; it would be a result simply of the commonplace that no finder of fact can see through the eyes of any other finder of fact. See Texas v. Florida, 306 U.S. 398, 411. Nor would inconsistency be created by a State court's concern for the protection of creditors which lead it to seize upon adoption of the outward form as the vital fact. So, indeed, might the taxing authorities refuse to be precluded from holding the taxpayer to his election to adopt the form of a partnership. Cf. Higgins v. Smith, 308 U.S. 473, 477. The need for guarding against misuse of the outward form of a partnership as a

device for obtaining tax advantages is properly satisfied by reliance on the vigilance of the Tax Court, not by distorting the concept of partnership. It is not for this Court, by redefinition or the erection of presumptions, to amend the Internal Revenue Code so as virtually to ban partnerships composed of the members of an intimate family group.

The present case, nevertheless, is not the first manifestation of an impression that the *Tower* opinion had precisely such an effect. It seems to me important, therefore, to make crystal clear that there is no special concept of "partnership" for tax purposes, while at the same time recognizing that in view of the temptations to assume a virtue that they have not for the sake of tax savings, men and women may appear in a guise which the gimlet eye of the Tax Court is entitled to pierce. We should leave no doubt in the minds of the Tax Court, of the Courts of Appeals, of the Treasury and of the bar that the essential holding of the *Tower* case is that there is "no reason" why the "general rule" by which the existence of a partnership is determined "should not apply in tax cases where the Government challenges the existence of a partnership for tax purposes."

In plain English, if an arrangement among men is not an arrangement which puts them all in the same business boat, then they cannot get into the same boat merely to seek the benefits of [§§701 and 702]. But if they are in the same business boat, although they may have varying rewards and varied responsibilities, they do not cease to be in it when the tax collector appears.

NOTE

1. *The result on remand.* On remand, the Tax Court found that the taxpayers did not intend in good faith to become partners. The court relied in part on a statement made by the father to a creditor that he and his wife had reserved unrestricted control over the property until the sons reached their majority. Rather than assume that this document was invalid, and that the father was guilty of obtaining credit under false pretenses, the court concluded that "it stated the real and true situation." Other facts inconsistent with a bonafide partnership were also found by the court. Culbertson v. Commissioner, ¶50,187 P-H Memo T.C. The Tax Court was again reversed by the Court of Appeals. As authority for the reversal, the Court of Appeals relied both on the Supreme Court's decision and on its own previous decision which had been reversed by the Supreme Court. The Court of Appeals found that the Tax Court had no more, and possibly less, evidence for its decision than it had had previously. The Court of Appeals also stated that the Supreme Court had misunderstood its "thoroughly considered and carefully reasoned opinion" and denied that "we held on the former opinion, hold now, or ever did hold to" the view attributed to it by the Supreme Court. Culbertson v. Commissioner, 194 F.2d 581 (5th Cir. 1952).

2. *The "Culbertson" ruling.* After watching the courts struggle with the *Culbertson* criteria for several years, the Internal Revenue Service in 1952 issued Mim. 6767, 1952-1 C.B. 111, "to clarify" its position "with respect to some aspects of the family partnership problem . . . concerning which there appears [!] to be uncertainty." But it was not possible in this area to single out relatively precise criteria for taxability, as was done in the Clifford Regulations, and the Service's position was consequently less clearly delineated. Moreover, since Congress intervened in 1951 with legislation, now §704(e), the ruling applied only to pre-1951 taxable years.

SENATE REPORT NO. 781

Senate Finance Committee, 82d Cong., 1st Sess. (1951)
1951-2 C.B. 458, 485-486

[Section 704(e)] is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of

property or business. Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income from personal services is attributable to the person rendering the services. There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or of a share of corporate stock, the rent or dividend income is taxable to the donee. Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner.

Although there is no basis under existing statutes for any different treatment of partnership interests, some decisions in this field have ignored the principle that income from property is to be taxed to the owner of the property. Many court decisions since the decision of the Supreme Court in Commissioner v. Culbertson (337 U.S. 733) have held invalid for tax purposes family partnerships which arose by virtue of a gift of a partnership interest from one member of a family to another, where the donee performed no vital services for the partnership. Some of these cases apparently proceed upon the theory that a partnership cannot be valid for tax purposes unless the intrafamily gift of capital is motivated by a desire to benefit the partnership business. Others seem to assume that a gift of a partnership interest is not complete because the donor contemplates the continued participation in the business of the donated capital. However, the frequency with which the Tax Court, since the *Culbertson* decision, has held invalid family partnerships based upon donations of capital, would seem to indicate that, although the opinions often refer to "intention," "business purpose," "reality," and "control," they have in practical effect reached results which suggest that an intrafamily gift of a partnership interest, where the donee performs no substantial services, will not usually be the basis of a valid partnership for tax purposes. We are informed that the settlement of many cases in the field is being held up by the reliance of the field offices of the Bureau of Internal Revenue upon some such theory. Whether or not the opinion of the Supreme Court in Commissioner v. Tower and the opinion of the Supreme Court in Commissioner v. Culbertson, which attempted to explain the *Tower* decision, afford any justification for the confusion is not material — the confusion exists.

The amendment [§704(e)] leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership, which the transferor purports to have given or sold him. Cases will arise where the gift or sale is a mere sham. Other cases will arise where the transferor retains so many of the incidents of ownership that he will continue to be recognized as a substantial owner of the interest which he purports to have given away, as was held by the Supreme Court in an analogous trust situation involved in the case of Helvering v. Clifford (309 U.S. 351). The same standards apply in determining the bona fides of alleged family partnerships as in determining the bona fides of other transactions between family members. Transactions between persons in a close family group, whether or not involving partnership interests, afford much opportunity for deception and should be subject to close scrutiny. All the facts and circumstances at the time of the purported gift and during the periods preceding and following it may be taken into consideration in determining the bona fides or lack of bona fides of a purported gift or sale.

Not every restriction upon the complete and unfettered control by the donee of the property donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationships

among partners. Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances, will not indicate any lack of true ownership in the transferee. In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit.

Since legislation is now necessary to make clear the fundamental principle that, where there is a real transfer of ownership, a gift of a family partnership interest is to be respected for tax purposes without regard to the motives which actuated the transfer, it is considered appropriate at the same time to provide specific safeguards — whether or not such safeguards may be inherent in the general rule — against the use of the partnership device to accomplish the deflection of income from the real owner.

Therefore, [§704(e)] provides that in the case of any partnership interest created by gift the allocation of income, according to the terms of the partnership agreement, shall be controlling for income tax purposes except when the shares are allocated without proper allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the allocation to the donated capital is proportionately greater than that attributable to the donor's capital. In such cases a reasonable allowance will be made for the services rendered by the partners, and the balance of the income will be allocated according to the amount of capital which the several partners have invested. However, the distributive share of a partner in the earnings of the partnership will not be diminished because of absence due to military service.

When more than one member of a family is a member of a partnership, all interests purchased by one member of the family from another will be treated as though the transfer were made by gift. For this purpose the family of an individual includes his spouse, ancestors, lineal descendants, and any trust for the primary benefit of such persons.

NOTE

1. *The Regulations under §704(e).* The student should examine the Regulations issued pursuant to §704(e), with respect to minors, trustees as partners, and limited partnerships. Regs. §704-1(e)(2). The tax treatment of these situations will greatly influence the use of §704(e) because by and large the donor of an interest in a family partnership will wish to retain control over its management, especially in view of the fact that any general partner may always bring a partnership to an end and force dissolution. Uniform Partnership Act, §§31(1)(b) and 31(2). Can the head of the family maintain control over the enterprise by taking in the children as limited partners only? By transferring their shares in the firm into trusts of which he is the trustee? By relying simply on his powers as the natural guardian of the children? For a discussion of the use of limited partnerships and trusts as partners under the pre-1951 law, see Toor v. Westover, 200 F.2d 713 (9th Cir. 1952).

Section 704(e)(1) applies only if capital is "a material income-producing factor." (Is §704(e)(2) similarly restricted?) For personal service family partnerships, see Poggetto v. United States, 306 F.2d 76 (9th Cir. 1962), applying the pre-1951 judicial criterion of "good faith intent to join together in the conduct of the enterprise."

2. *Section 704(e) in practice.* There has been surprisingly little litigation on the validity of §704(e) partnerships since its enactment in 1951. The following extracts from two cases — one honoring, the other rejecting, the partnership form — are typical of judicial attitudes.

Reddig v. Commissioner, 30 T.C. 1382, 1392, 1393 (1958):

When we consider all of the factors in this case, as disclosed by the circumstances at the time the trust and partnership agreements were executed, the terms of said instru-

ments, and the conduct of the parties thereafter, we are convinced respondent was correct in holding the trustee for the Reddig and Kalat children was not the real owner of partnership interests for income tax purposes in the Maxwell Company within the meaning of the statute. The donors of the capital interests to their children in trust retained too many controls over the subject matter of the gifts to warrant a holding that the trustee in each instance was the real owner of the capital interests conveyed within the meaning of the statute.

In the trust agreements, we find the trustee selected is the law partner of petitioners' attorney representing them in this case. The undivided interest in the property is given in trust to the children but the same sentence in the two instruments directs the trustee to contribute the interest to the partnership. The trust agreements use language of absolute conveyance as if the donors were parting with all of their interests in the donated partnership interests but actually the instruments are loaded with clauses and provisos designed to curtail the ownership rights of the donees and make sure important controls will be retained by the donors.

The trustee is given the right to pay income or corpus to or for the benefit of the beneficiaries but also "in his sole and absolute discretion" to make such payments to the persons "with whom such beneficiary shall reside." In 1952 the Reddig children were 12 and 15 years old and the three Kalat children were 2, 8, and 10 years old. Presumably the children beneficiaries resided with their parents, the grantors. The clause would seem to authorize the trustee to pay corpus and income to the grantors.

Clause 5 of the trust instruments, which we have set forth in our Findings of Fact, is replete with confusing language, but the general design seems to be to have the trustee act, especially with regard to the distribution of partnership earnings, in the interest of the partnership, as the donor partners shall determine even though such action would conflict with the duty of the trustee to act in the best interest of the beneficiaries. The trustee is not to be held accountable so long as he acts in good faith "in the furtherance of Grantors' intentions as expressed in or implied by this instrument." It is perfectly apparent from a reading of the entire trust agreement the donees received much less than full and complete ownership and the donors emerged from the gift transaction with strings over the donated property that they could pull for their own advantage.

The retention of control on the part of the donors is increased when we turn to the next instrument, the partnership agreement. By the trust agreement the undivided interest in the property that made up the trust estate in each trust had to be contributed to the Maxwell Company partnership. The partnership was completely dominated and controlled by the "individual parties" or the grantors of the trust agreements. Henry S. Reddig had more control than the others but the point is the trustee partner had almost no voice in the conduct of the business.

While any partner was given the right to withdraw, liquidation and dissolution would not result unless those owning more than one-half of the capital interest elected to so do. Those owning more than one-half of the capital interest were the individual partners or grantors of the trusts. It is clear that if the trustee partner chose to withdraw he could not sell his interest at fair market value. Cf. Hargrove Bellamy, 14 T.C. 867. If there were no election to dissolve or liquidate, the withdrawing partner was deemed to have elected to sell his interest at book value without allowance for goodwill, trade names, patents, or other intangible assets. Provision is made in the partnership agreement for Elmer Kalat to purchase the capital interest of any of his children who die and for the Reddigs to purchase the capital interest of any of their children who die but if Kalat should die, the partnership is to terminate and the trustee for the Kalat children is to withdraw and Kalat's estate and the trustee for his children are to be paid *from the partnership*, for the value of the Kalat interest, and the value of the trust interest for the Kalat children, and Henry and Thelma Reddig "shall be deemed to own an equal portion of such interests so acquired by the partnership." In the latter contingency it is to be noted partnership earnings in which the trustee of the Reddig children would have a 40 per cent interest, would be devoted to purchasing a capital interest of other partners.

We do not feel that further detailed analysis of the trust and partnership agreements is necessary to show that the transactions were each nothing more than a sham

or pretense of donating capital interests in the Maxwell Company. The ownership of the donees was not the real ownership contemplated by the statute and the Commissioner's regulations. They were not bona fide gifts of capital interests uncontrolled by the donors.

Smith v. Commissioner, 32 T.C. 1261, 1269, 1270 (1959):

> Respondent argues the retention of control over the interests purportedly given to the trusts can be found in the trust instruments, partnership agreement, and other documents and it is also revealed by the conduct of the parties. The documents were legally sufficient to accomplish the gifts. It is true the partnership agreement gave broad management control to Jack and the capital ownership of Jack and Rose together gave them a dominant interest in the partnership. However, it seems quite normal that petitioners, who ran the business, and especially Jack, who had started it, should have superior management control. The mere fact that the trusts had a minority voting position does not mean the donors retained control over the donated interests. We have not set forth the documents, but insofar as they speak for themselves, each establishes its own validity on its face. Respondent admits the validity of the trusts and recognizes them as taxable entities. Respondent does not assail the sufficiency of the partnership instrument to create a partnership at least as to Jack and Rose. As stated, we do not think the mere presence in the partnership agreement of clauses giving Jack superior management control should mean the trusts should be excluded. We do not find anything in the instruments providing retention of control by the donor sufficient to show the donees were not the real owners of the partnership interests.
>
> The reality of the donees' ownership of interests in the partnership is not established by the legal sufficiency of the instruments of gift and partnership. In these family partnership cases the donor parents often are, as respondent suggests in the instant case, in a position to impose their will as parents, and reduce what appears to be a gift, to a mere sham. This is especially true when the donees are young children. The conduct of the parties is to be closely scrutinized to see if the parents treated all the related transactions as creating, in reality, bona fide gifts of the partnership interests. Here the record shows the parents' general recognition of the trusts as owners of partnership interests; their disclosure to the partnership customers, creditors, and bank that the trusts were partners; the fact that they filed notice under fictitious name statutes that the trusts were partners; a recognition of the trusts as partners in the partnership returns; the proper distribution of the partnership profits to the trusts as partners; and, finally, recognition of each trust as owner of a 15 per cent capital interest in the 1956 incorporation of the partnership business where each trust received a 15 per cent stock interest.
>
> Respondent points to petitioners' acts in having the partnership's donations to charities charged to their shares of partnership profits so they could take the deductions on their individual income tax returns, as showing retention of control. We fail to see how such acts demonstrate any nonrecognition of the trusts as partners.
>
> The conduct of petitioners with respect to the trusts is also to be examined. Here the record shows the trust funds were invested in bonds, savings and loan associations, and real estate ventures. Trust funds were not spent for the support or education of the children. Partial distribution was made to Howard when he reached 25 years of age, as the trust provided.

See also Pflugradt v. United States, 310 F.2d 412 (7th Cir. 1962); Spiesman v. Commissioner, 260 F.2d 940 (9th Cir. 1958); Stanback v. Commissioner, 271 F.2d 514 (4th Cir. 1959); Finlen v. Healy, 187 F. Supp. 434 (D. Mont. 1960).

3. *Reasonable compensation for donor's services.* What criteria will determine whether "reasonable compensation" has been allowed to the donor for his services? See Patton v. Commissioner, supra page 267. Does the requirement of such an allowance destroy the usefulness of the family partnership as a tax reduction device? Under the pre-1951 law, it was held in several cases that a family partnership was either valid in toto or invalid in toto. Thus, in Canfield v. Commissioner, 168 F.2d 907 (6th Cir. 1948), the Tax

Court was reversed for holding, in disregard of the partnership agreement, that 75 per cent of the firm's income should be attributed to the husband's services (and taxed to him) and that the remaining 25 per cent should be attributed and taxed to husband and wife in proportion to their capital interests. See also Hartz v. Commissioner, 170 F.2d 313, 318 (8th Cir. 1948), stating, however, that an "artificial" allocation of income among the partners "might constitute sufficient ground for a finding that the alleged partnership was a sham or a device to avoid the payment of taxes." Mim. 6767, supra page 394, however, expressed the view (for years before 1951) that in some cases the partnership should not be totally disregarded, but income should be allocated according to the values of services and capital rather than according to the agreement itself. Reallocation in appropriate cases was endorsed in Weiss v. Johnson, 206 F.2d 350, 354 (2d Cir. 1953):

> No reason is perceived in either law or logic why, if a partnership may be found wholly invalid for a misuse of this business device as an instrument of tax evasion, it may not also be found partially invalid for a like ground.

See also Wofford v. Commissioner, 207 F.2d 749 (5th Cir. 1953), where, although an alleged partner was not recognized as such, its ownership of a portion of the capital used by the firm was acknowledged, and part of the firm's income was held to be compensation for the use of the "partner's" capital.

4. *Disregard of partnership form at behest of taxpayer.* Occasionally the head of the family wishes to disregard a purported partnership in order to apply the firm's entire loss against his own (high-bracket) income, rather than allowing some of the loss to be "wasted" on a child's return. See Maletis v. United States, 200 F.2d 97 (9th Cir. 1952), cert. denied, 345 U.S. 924 (taxpayer estopped to deny partnership); Bialock v. Commissioner, 35 T.C. 649 (1961) (on facts, no estoppel).

5. *Pooling of "outside" income by partners.* A and B are members of an admittedly valid partnership for the conduct of a real estate and accounting business. The partnership agreement provides that all "outside" income received by either of them shall be contributed to the partnership and distributed between them in the same proportion as the income from the business activities of the firm. Is the arrangement as to "outside" income effective for federal income tax purposes? Mayes v. United States, 207 F.2d 326 (10th Cir. 1953); Mayes v. Commissioner, 21 T.C. 286 (1953). Can two lawyers, each having a retainer from a separate client, become partners by pooling their income and expenses, if neither performs any services except for his "own" client?

6. *References.* Comment, Family Partnerships and the Revenue Act of 1951, 61 Yale L.J. 541 (1952); Beck, Use of the Family Partnership as an Operating Device — The New Regulations, 12 N.Y.U. Inst. on Fed. Taxation 603 (1954); Bruton, Family Partnerships and the Income Tax — The Culbertson Chapter, 98 U. of Pa. L. Rev. 143 (1949) (for pre-1951 case law).

4. *Family Corporations*

OVERTON v. COMMISSIONER
OLIPHANT v. COMMISSIONER

162 F.2d 155 (2d Cir. 1947)

Before SWAN, AUGUSTUS N. HAND and FRANK, Circuit Judges.

SWAN, Circuit Judge.

These appeals involve gift tax liability of petitioner Overton for the years 1936 and 1937 and income tax liability of petitioner Oliphant for the year 1941. Each petitioner was held liable on the theory that dividends received by his wife in the year in question on stock registered in her name on the books of Castle & Overton, Inc., a New York corporation, were income of the husband for tax purposes. No gift tax return with respect to such dividends was filed by Mr. Overton in 1936 or 1937, and the dividends received by Mrs. Oliphant in 1941 were not included in her husband's return for that year.

There is no dispute as to the evidentiary facts. They are stated in detail in the opinion of the Tax Court, 6 T.C. 304, and will be here repeated only so far as may be necessary to render intelligible the discussion which follows. On May 26, 1936 the corporation had outstanding 1,000 shares of common stock without par value but having a liquidating value of at least $120 per share. On that date, pursuant to a plan devised to lessen taxes, the certificate of incorporation was amended to provide for changing the outstanding common stock into 2,000 shares without par value, of which 1,000 were denominated Class A and 1,000 Class B. The old stock was exchanged for the new, the shareholders then gave the B stock to their respective wives, and new certificates therefor were issued to the wives. The B stock had a liquidating value of one dollar per share; everything else on liquidation was to belong to the holders of the A stock, who had also the sole voting rights for directors and on all ordinary matters.[1] By virtue of an agreement made in April 1937 restricting alienation of their stock, the wives were precluded from realizing more than one dollar a share by selling their shares.* The A stock was to receive noncumulative dividends at the rate of $10 a share per year before payment of any dividend on the B stock; if dividends in excess of $10 per share were paid on the A stock in any year, such excess dividends were to be shared by both classes of stock in the ratio of one-fifth thereof for the A stock and four-fifths for the B stock. During the six year period ending in December 1941, the dividends paid on B stock totaled $150.40 a share as against $77.60 a share paid on A stock. In 1941 the A stock had a book value of $155 per share.

The Tax Court was of opinion that the 1936 arrangement, though made in the form of a gift of stock, was in reality an assignment of part of the taxpayers' future dividends. Unless form is to be exalted above substance this conclusion is inescapable. Since the total issue of B stock represented only $1,000 of the corporate assets, it is plain that the property which earned the large dividends received by the B shareholders was the property represented by the A stock held by the husbands. In transferring the B shares to their wives they parted with no substantial part of their interest in the corporate property. Had they been content to transfer some of the original common stock, they could have accomplished their purpose of lessening taxes on the family group,[2] but they would then have made substantial gifts of capital. The arrangement they put into effect gave the wives nothing, or substantially nothing, but the right to future earnings flowing from property retained by the husbands. That anticipatory assignments of income, whatever their formal cloak, are ineffective taxwise is a principle too firmly established to be subject to question. . . . We think the Tax Court correctly applied this principle to the facts of the case at bar.

Orders affirmed.

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[1] Whether the amendment of the certificate of incorporation excluded B shareholders from voting on extraordinary matters specified in section 51 of the Stock Corporation Law of New York, McK. Consol. Laws, c. 59, in effect on May 26, 1937, the Tax Court did not find it necessary to determine; nor do we.

* The Tax Court did not find that the 1937 shareholders' agreement was planned when the stock was transferred in 1936; indeed, the court implied that it was not prearranged. 6 T.C. 304, 313 ("This restrictive agreement was entered into after the transactions of June 10, 1936, and is therefore not controlling. Nevertheless, it is, in our view, corroborative, for it demonstrates the willingness of the wives unhesitatingly to give up valuable rights without consideration, even in the face of prior receipt of large dividend payments"). — Ed.

[2] See Blair v. Commissioner, 300 U.S. 5.

COMMISSIONER v. LAUGHTON

113 F.2d 103 (9th Cir. 1940)

Before DENMAN, MATHEWS, and STEPHENS, Circuit Judges.

DENMAN, Circuit Judge.

This is a review of a decision of the Board of Tax Appeals holding Laughton not liable for income taxation for moneys paid in the tax years 1934 and 1935 by various American motion picture producers to Motion Pictures & Theatrical Industries, Ltd., a British corporation, hereafter called Industries, Ltd., all of whose shares, except those qualifying the directors, were owned by Laughton, for services in the United States rendered by that company to the American producers by supplying Laughton, an employee of Industries, Ltd., as an actor in their motion pictures.

Laughton was employed as an actor by the company under an exclusive contract for five years at a salary very much less than that the company received for "loaning" him to the producers. Such hiring and loaning is established practice in the moving picture industry. The Commissioner contends that the corporate entity should be ignored for income tax purposes and the compensation deemed paid directly from the producers to Laughton. The Board held the corporation had a business purpose and hence its entity intervened.

The Board decision was made before the Supreme Court decided Higgins v. Smith, 308 U.S. 473, which we consider controlling this proceeding. In that case Smith, the taxpayer, dominated a corporation of which he owned all the shares through

> officers and directors [who] were [his] subordinates. . . . While its accounts were kept completely separate from those of the taxpayer, there is no doubt that Innisfail [the corporation] was his corporate self.

That is to say, the corporation was "wholly owned" both as to management by the taxpayer's subordinates and as to stock interest.

Smith, having in mind reducing his taxes, sold to this "corporate self" certain of his shares of stock at a loss, which he claimed as a deduction from his taxable income. It was held that, assuming title had passed to his corporate self, he had such a command of the securities thereafter that "There is not enough of substance in such a sale finally to determine a loss."

In a long discussion the court, inter alia, states that

> Indeed this domination and control is so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity.

That the phrase "wholly owned" in this dictum regarding an instruction to the jury means something more than mere stock ownership is to be inferred from a ruling at the end of the opinion. There certain evidence of past transactions between taxpayer and corporation was admissible because the court thought "it apparent that this evidence was entirely relevant to the present issue; the history of the taxpayer's relations with the corporation shed considerable light on the actual effect of the sale in question."

Later, considering Burnet v. Commonwealth Improvement Company, 287 U.S. 415, in which the sole stockholder so utilized the corporation that it made a book profit and the corporation was held liable as a separate taxable entity, the court says:

. . . A taxpayer is free to adopt such organization for his affairs as he may choose and having elected to do some business as a corporation, he must accept the tax disadvantages. On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged *tax event is unreal or a sham* may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayers to supercede legislation in the determination of the time and manner of taxation. It is command of income and its benefits which marks the real owner of property. (Emphasis supplied.)

It is arguable that the *Higgins* decision means that no matter what the particular "tax event" may be, if it be more profitable to the tax collector to disregard the intervening corporate entity this must be done. However, it seems to us that if this were the intent of the court it would have said so and not spread its consideration of the cases over many pages of the opinion with such qualifying language as is quoted above.

We take the opinion to mean that the "tax event" is not an unreal attempt to use a corporation for a sham transaction, procuring an advantageous tax consequence to the taxpayer, if it may be considered as one primarily for an independent business purpose and not a transfer of assets (here Laughton's services), with a retention of their control, solely to reduce tax liability.

Applying this criterion to the instant case the question here is not whether Industries, Ltd., was formed for a business purpose. The corporation in Higgins v. Smith, supra, was formed and used for profitable business purposes causing it to pay federal and state income taxes. The question is whether Laughton's hiring of himself to Industries, Ltd., for a salary substantially less than the compensation for which the corporation supplied his services as its employee to various motion picture producers, constituted, in effect, a single transaction by Laughton in which he received indirectly the larger sum paid by the producers.

The Board made no finding on this issue. It seemed to think it sufficient to find no more than that the corporation itself had a business purpose. This places before us the determination whether the evidence warrants us to return the case to the Board with the freedom to make such a finding, or whether it permits only the finding that Laughton's transaction with regard to his services to the corporation is an "unreal and/or a sham" attempt at tax avoidance.

There is evidence here from which it might be inferred that tax avoidance by a sham transfer by Laughton of his services was the primary purpose of the use of the corporation. There is also evidence from which it may be inferred that it was not. The testimony is uncontradicted that Laughton had no intention to avoid taxes; that the purpose of engaging himself for five years as an employee of Industries, Ltd., was to join his efforts with other employees of the company to create motion pictures; that he contributed six thousand pounds to the capital of the company for his stock interest, other than the qualifying shares of his directors, and also royalties in certain enterprises in which he was interested; that he contemplated that the corporation would gather further accretions of capital by its use of his services as its agent for a time to other motion picture producers.

It is also uncontradicted that during the two tax years in question, 1934 and 1935, sufficient capital was accumulated from all these sources for the corporation's active engagement in motion picture production at a later date; that the directors of his company were not dominated and controlled by him as in the case of Higgins v. Smith, supra, that, on the contrary, they were business men who ran the business with a free hand and never asked Laughton's permission in its conduct.

It is a matter of law that the stockholders have no right to direct the conduct of the board of directors.

It is also uncontradicted that Laughton's motive was based on the theory

> that as an actor he would die poor. He had a Gerald DuMaurier in mind who died poor and he said that he was determined while he was on the crest of the wave to safeguard his resources, that he would engage the services of the finest writers in New York and technicians and cameramen and form a renaissance of the British film industry.

Laughton is an English actor and was then an artist of international renown. The Board properly could infer that one with the artistic temperament is likely to dissipate his income and that Laughton was farseeing enough to desire that compensation for his genius should be handled by independent business men.

On the other hand, it appears that Laughton borrowed heavily on secured loans from Industries, Ltd., during the tax years in question. He had a previous engagement for his services which was surrendered to the company, followed by a similar engagement directly with the company to furnish them as its employee. The minutes of the company show that he was present at many of the directors' meetings. Also there was a very wide disparity between the salary he received from the company and what he had previously been receiving as a motion picture actor, and a still wider disparity between his company salary and what was received by the company for his subsequent services.

We cannot say as a matter of law that findings of ultimate fact must be made one way or the other with reference to the issue as stated above. The administrative body must be left free to make its own inferences relevant to that issue. Our sole function with regard to administrative findings is to determine whether there is any substantial evidence to support them.

We hold that the case must be returned to the Board to make the findings this opinion indicates are required.

Remanded.*

NOTE

1. *A "family corporation" doctrine?* As is indicated infra page 629, a corporation like the one organized by Laughton may be subject to the virtually confiscatory personal holding company surtax if the bulk of its income comes from "hiring out" the services of a stockholder unless the income is distributed annually as earned. Many family corporations can avoid these special provisions, however, even though the corporate income may be created largely by the personal skill or services of the head of the family. By giving some of the stock to members of the family, he may reduce income taxes unless the corporate entity is disregarded and the income of the corporation is taxed to him.

Note the court's remark in the *Overton* case, supra:

> Had they been content to transfer some of the original common stock, they could have accomplished their purpose of lessening taxes on the family group, but they would then have made substantial gifts of capital. [162 F.2d at 156.]

Suppose the husband's services are a principal source of the corporation's earnings, and his compensation is inadequate. Could the Commissioner include in the husband's income a "constructive" salary to give him adequate compensation for his services? Or could the Commissioner treat dividends subsequently paid to the wife and children as assignments of the husband's past earnings? If a family partnership, after being held invalid for tax purposes, is incorporated, and the stock is divided among the former "partners" in proportion to their capital interests, will the Commissioner have any ground for attacking the arrangement? See Alexandre, The Corporate Counterpart of the Family

* The proceedings on remand are not reported. — Ed.

Partnership, 2 Tax L. Rev. 493 (1947); Johnson, Taxing Dividends of Family Corporations — A Dissent, id. at 566.

2. *Effect of separate corporate tax.* Assuming that the husband can take an inadequate salary without jeopardizing the normal tax treatment of a corporation (separate tax on corporate earnings; dividends taxed to stockholders only when paid), what are the tax pressures that discourage use of this device for income-splitting?

3. *Subchapter S corporations as an income-splitting device.* By virtue of §§1371-1377, enacted in 1958, many closely held corporations are entitled to elect to be taxed, in many respects, as partnerships: the electing corporation pays no corporate income tax, its income being taxed directly to the shareholders, whether it is distributed to them or accumulated by the corporation. On the use of such "Subchapter S corporations" as a means of splitting income within the family without incurring a separate income tax or running afoul of the "imputed compensation" provision of §704(e) (family partnerships), see page 744 infra.

5. *Other Intra-Family Arrangements and Transactions*

HENSON v. COMMISSIONER
174 F.2d 846 (5th Cir. 1949)

Before SIBLEY, HOLMES, and McCORD, Circuit Judges.

McCORD, Circuit Judge.

This is an appeal from a decision of the Tax Court sustaining a deficiency assessment against petitioner on income taxes alleged to be due for the year 1943.

The question presented is whether the Tax Court properly held $22,348.78 profit of the J. M. Henson Company for the period from August 1, 1943, to December 31, 1943, was taxable to petitioner as his income, even though on the former date he had executed a valid and complete gift of this Company to his wife.

The material facts are without dispute, and reveal that petitioner and his wife were married in the year 1925, and reside in Atlanta, Georgia. Sometime prior to August 1, 1943, petitioner became the owner of two business concerns known as the J. M. Henson Company, a baker's supply business, and the Dairy and Ice Cream Supply Company. The two businesses were located in the same building, used the same offices, equipment, bookkeeper and stenographic help, but did not have the same salesmen or customers. Separate sets of books were kept and different letterheads were used, and the inventories and bank accounts were maintained separately. There were three other people besides petitioner who shared in the profits of the Dairy and Ice Cream Supply Company, while petitioner alone received the profits of the J. M. Henson Company.

On August 1, 1943, petitioner conveyed to his wife, a woman of little business experience, his entire ownership and interest in the J. M. Henson Company. On the same day, Mrs. Henson wrote their bank in Atlanta a letter giving petitioner, her husband, authority to sign checks, drafts and notes for the company.[1] Later, petitioner filed an affidavit with the clerk of the county court, stating that his wife was the sole owner of the business. A similar notice was published in a paper of general circulation throughout the county. In 1944, petitioner filed a gift tax return, disclosing the gift of this Company to his wife, and paid the gift tax thereon. His wife also filed a donee's information return, and paid the tax on income earned by the Company from the date of the gift until the end of the year 1943.

After August 1, 1943, the J. M. Henson Company continued to operate under

[1] It is without dispute that after receiving such notice the bank would not lend money to the Henson Company unless the notes were signed by Mrs. Henson.

substantially the same conditions and under the same name, except that petitioner was retained by his wife as manager of the company at a salary of $300.00 per month, which was substantially the same amount he had withdrawn for his services prior to the transfer. He maintained a personal account for himself and charged his expenses to it. His wife had no office in the place of business and was not normally consulted as to its operation and direction. Petitioner alone drew checks on the Company's bank account, in accordance with the grant of such authority from his wife. However, it is undisputed that after the date of the transfer, which was admittedly a bona fide gift and effective to pass title to the property under Georgia law, that petitioner's wife was the sole and absolute owner of the Company, with no strings attached. She had the right and absolute power to dispose of it by gift, sale, or will. She further had the power to borrow money on account of the business, and to employ and discharge managers or other company employees at will, although she never saw fit to exercise her prerogative in the latter respect during the tax year involved. Under and by virtue of the gift to his wife, petitioner had irrevocably divested himself of all legal title, right, interest, and control over the business, and remained as manager of the Company solely at his wife's pleasure. In fact, it appears that since March 1, 1944, or shortly thereafter, petitioner has no longer managed the Company, nor has he drawn any salary whatever from the Company account for his services, at least insofar as this record reveals.

We are of opinion the Tax Court erred in holding petitioner taxable on the income from the Company after he had executed an absolute gift of such business to his wife. Blair v. Commissioner [supra page 350]. . . . This case involves a valid and unconditional gift, complete and effectual for all purposes, and is clearly distinguishable from those family partnership tax cases relied upon by the Commissioner. . . .

The Tax Court has evidently, in its decision, failed to recognize the distinction between actual control over income-producing property with consent of the true owner, and the absolute right of control over both the property and the income derived therefrom which adheres in a valid and legal title. The controlling question in such cases is, therefore, not whether actual control over the property is exercised, but whether the right of control in fact exists; not who earns the income from such property, but who has the right to receive it. Cf. Werner v. Commissioner, 7 T.C. 39.

Every owner of a business, particularly those of limited business experience, has the undoubted right to have it managed by another, even though that person be married to the owner. Moreover, every husband has a legal right to create a valid gift of his property in favor of his wife without being held liable for the income tax thereon, provided, of course, there are no conditions attached which would enable him to retain a legal dominion and control over the property, or to revoke the transfer. No such conditions are found to exist here. In this case, the wife was no partner, but became the undisputed and absolute owner of the business, under and by virtue of the gift from her husband. Under such circumstances, the income therefrom was taxable to her alone, and not to the petitioner. . . .

It follows that the decision of the Tax Court should be, and the same is hereby reversed.

NOTE

1. *Transfers of a family business.* Was it crucial that the husband's salary was equal to his previous withdrawals? Was $300 per month the value of the husband's services, the rest of the profits being attributable to capital?

In Visintainer v. Commissioner, 187 F.2d 519 (10th Cir. 1951), part of the income of a sheep ranch business was held taxable to minor children. Their father, who managed the business, gave some of the sheep to the children. The transferred sheep were branded, but were not separated from the herd. The income and expenses of the entire business were divided among the father and children in proportion to the sheep owned. The Tax Court held that, although the father "stopped one step short of the usual family partnership — the execution of the partnership agreement," the entire income of the business should be taxed to him under the *Tower* case. The Court of Appeals reversed, holding that there were bona fide gifts of the sheep to the children and that the income followed the sheep. See also Alexander v. Commissioner, 190 F.2d 753 (5th Cir. 1951); Sandberg v. Commissioner, 8 T.C. 423 (1947); Fellows Sales Co. v. United States, 200 F. Supp. 347 (D.S.D. 1961). For another approach in a comparable context, see Hogle v. Commissioner, 132 F.2d 66 (10th Cir. 1942), which is summarized in Commissioner v. Hogle, infra page 1023.

2. *Sale of property, payment to be made with income.* See Fitzgibbon v. Commissioner, 19 T.C. 78 (1952), involving a "sale" of stock by a mother to her children, the purchase price to be paid in installments out of the dividends received (less income tax thereon) by the children. The court found that the transaction was not a bona fide sale, and held that the dividends were taxable to the donor. See also the cases involving sales of businesses to charities, payment to be made largely or solely from future income, infra pages 512-513.

WHITE v. FITZPATRICK

193 F.2d 398 (2d Cir. 1951), cert. denied, 343 U.S. 928 (1952)

Before AUGUSTUS N. HAND, CHASE, and CLARK, Circuit Judges.

CLARK, Circuit Judge.

Involved in this appeal is the recurring problem of tax savings claimed as a consequence of a transfer of property from husband to wife with resulting lease or license back. Here neither the Commissioner of Internal Revenue nor the district court has accepted the taxpayer's view of the transactions; and he now appeals from the judgment against him in his action for a refund of the deficiency assessed against him by the Commissioner upon his income and victory taxes for the years 1941, 1943, and 1944.

The following are the facts of the case as stipulated by the parties and found by the trial court. During the years in question and for some time prior thereto, plaintiff engaged in the manufacture of chokes for use on the barrels of shotguns, as sole proprietor of the Poly Choke Company, an unincorporated business. Beginning in 1939 the company occupied certain properties — land, three factories, a garage, and an office — under a lease coupled with a nontransferable option to purchase for $15,370. Plaintiff had developed the basic invention for this device himself and obtained a United States patent for it on December 27, 1932.

On January 21, 1941, he entered into a written agreement with his wife, transferring "the entire right, title and interest in and to" the patent, "to the full end of the term of said patent," for a stated consideration of $10. The following day his wife licensed the exclusive manufacturing right back to him "to the full end of the entire term of said patent." The assignment back was subject to cancellation only if (a) payments fell into sixty days' arrears, or (b) receivership, bankruptcy, forced assignment, or other financial difficulty made it impossible for her husband to carry on his manufacturing concern. It provided for royalties of $1 on each product marketed. Plaintiff filed a gift tax return for the year declaring the fair market value of the patent to be $10,000 and for the next four years, 1941-1944 inclusive, paid his wife some $60,000 as royalties.

At about the same time, December 27, 1940, plaintiff's wife also purchased the property on which the company was located for $16,800 and immediately leased

it to her husband orally. On the next day plaintiff made a gift to his wife of $16,175 to cover the purchase price and filed a gift tax return for that amount. Rental payments for the years 1941-1944 inclusive were $1,500 a year, which was the amount that plaintiff had been paying to the original lessor; in 1944, plaintiff in addition paid his wife some $5,000 as "an adjustment in rent."

During the years in question plaintiff deducted both rental payments and royalties as business expenses. After investigation and audit, the Commissioner of Internal Revenue issued a deficiency notice disallowing the deductions in 1948. Plaintiff paid the total deficiency of about $47,000 thus assessed and brought this action for refund. The district court found (1) that the plaintiff's motivation was to make good certain losses in the value of securities held by his wife and to minimize income taxes for the family group, but (2) that

> it was the taxpayer's expectation that no action would be taken by the wife in exercise of her rights of ownership of the patent or real property which would be detrimental to the plaintiff's interests.

The court then concluded that by the gifts and license and lease back

> by reason of the family relationship the husband retains effective control of the patent and real property, while valid transfers for other purposes, will not form a valid basis for deduction of royalties and rent paid by the husband to the wife as business expenses in arriving at the taxpayer's net income for income tax purposes.

The bare assignment of the patent was legally adequate to transfer all rights adhering thereto to the wife. Likewise the land was purchased in the name of the wife alone. From this plaintiff contends on appeal that the wife's legal title and power were absolute and subject to no conditions or future claims whatsoever. Moreover, there is no evidence, nor does defendant contend, that the plaintiff derived any direct benefit in the form of income from these transactions. Therefore, plaintiff argues that, since the royalties and rents were both ordinary in nature for his type of business and reasonable in amount, they constitute valid business expenses under [§162(a)], which authorizes the deduction from gross income of "ordinary and necessary expenses" paid "in carrying on any trade or business."

Underlying reality, however, contradicts this appearance of a complete assignment. "Title" to the patent and land may legally reside in the plaintiff's wife; practically and actually, as the district court concluded, control rests with the husband as effectively as if he had never made the gift of the patent to his wife or given her the money with which to buy the property.* Assignment and gift cannot be divorced for tax purposes from their accompanying agreements whereby the husband retained dominion. And in fact plaintiff never intended that it should be; he admitted the impossibility of conducting the business without this basic patent or of finding a comparable factory site in Connecticut. His wife was neither equipped nor evinced any desire to exercise or transfer any rights to the use of either of the properties; in the case of the patent at least, it is clear that she had no legal right to do so, save in the unlikely event of the husband's default.

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* From the District Court's opinion: "Mr. White, after the assignment and the contemporaneous license agreement, retained a substantial measure of control over the patent. His determination of the most desirable volume of production of the poly choke would govern the amount which his wife would receive as royalties; he had the right to decide whether or not to grant sublicenses under the patent. And in addition, it may be assumed that, owing to the marital relationship, he had a degree of control, not readily measurable in legal terms, over the patent and license agreement. It is not to be thought, in the light of Mr. White's testimony, that his wife would have been unwilling to submit to any alteration or modification of the existing arrangement which he might deem expedient. As he put it, he 'owns the wife.'" 43 A.F.T.R. 1169, 1174 (D. Conn. 1951) (not officially reported). — Ed.

The sole practical effect of these transactions, therefore, was to create a right to income in the wife, while leaving untouched in all practical reality the husband-donor's effective dominion and control over the properties in question. It is not without significance on this point that the arrangement made was actually disadvantageous to the business. For it passed over the reduction of land charges which the taxpayer might have made by taking up his option to purchase in order to create the income right in the donor's wife, and that, too, at a greater capital cost. For the statutory purposes, the mere creation of a legal obligation to pay is not controlling. Interstate Transit Lines v. C.I.R., 8 Cir., 130 F.2d 136, affirmed 319 U.S. 590.

In this respect, then, the case before us does not involve the definite problem presented by the completed assignment of a created product which divided our court and the Fourth Circuit, both inter- and extra-murally, in the two cases of Wodehouse v. C.I.R., 2 Cir., 177 F.2d 881, Id., 4 Cir., 178 F.2d 987. Gift and retained control must be regarded as inseparable parts of a single transaction, especially since it was only in their sum total that they had any reality in regard to the conduct of plaintiff's business. To isolate them, as would be necessary to bring them within the rationale of our own majority ruling in Wodehouse v. C.I.R., supra, is to hide business reality behind paper pretense.

For the question here is as to the tax consequences of a formal gift of certain income-producing properties by the husband to his wife coupled with the informal retention of administrative control — the transfer, in effect, of the right to receive income and the retention of those complex of "use rights" which are usually compressed in the term "ownership." In the context of [§162(a)], the question is a rather new one; under [§61(a)], where it arises in the definition of gross income problems, it is not. And we think the line drawn in the precedents under the latter section is the same as that in the field of deductibility of business expenses. Plaintiff here, for example, accepts as his own the income he has received on the patent equivalent to the royalties he is paying his wife, but then seeks to deduct it as a business expense; in effect this is not different from claiming that the gift itself made the original income hers in the first place.

We think, therefore, that the principles governing the intermarital transfer of income enunciated in Helvering v. Clifford, 309 U.S. 331, and re-enforced by later cases, are also decisive here. In the case at bar, plaintiff assigned the "legal title" to the patent and provided for his wife's assumption of the "legal title" to the land; but he retained, by formal agreement in the first case, by informal arrangement in the second, the administrative control of these properties. His wife had the right to income, but he had a right to the use of the patent and land. Henson v. C.I.R., 5 Cir., 174 F.2d 846, is thus distinguishable. The *Clifford* rule is clear, that this direct control, when fused with the indirect control which we must imply from a formal but unsubstantial assignment within the closed family group displaying no obvious business purpose, renders the assignment ineffective for federal tax purposes. The same result should obtain whether the question arises under [§61(a) or §162(a)] of the Internal Revenue Code.

Plaintiff relies heavily on Skemp v. C.I.R., 7 Cir., 168 F.2d 598, and Brown v. C.I.R., 3 Cir., 180 F.2d 926, certiorari denied, 340 U.S. 814. These cases, which are criticized in reasoned discussions in 51 Col. L. Rev. 247 and 59 Yale L.J. 1529, may be thought to go to the verge of the law in support of what are essentially intrafamily transfers. But both, being to trustees, were sufficiently outright, to be distinguishable from our present case. Both involved claimed deductions under [§162(a)]. In the first, a plaintiff-physician had deeded the building in which he had his office in irrevocable trust for twenty years or until the prior deaths of both himself and his wife, with their children as beneficiaries. He then

leased the building back for ten years. In the second, there were two trusts, also irrevocable, terminating on the majority of the beneficiaries who were children of the settlor, coupled with an immediate lease back of the corpus properties. In upholding the deductions, both courts expressly emphasized the independence of the trustees. It is probable that a like result would probably have obtained had the question been one of gross income under I.R.C. [§61(a)]. For three factors determine attributability of income to the settlor of a family trust. Whether these are conjunctive tests, see Helvering v. Clifford, supra, 309 U.S. at 335, or alternative, under the new *Clifford* regulations, U.S. Treas. Reg. No. 118, §39.22(a)-21; Kay v. C.I.R., 3 Cir., 178 F.2d 772, it seems likely that in both the cases relied on, income would have been attributable to the trusts and thus to the beneficiaries, rather than the settlors. For (1) the settlors retained no reversionary interests; (2) they retained no dispositive power over either corpus or income; [1] and (3) administrative control was not exercisable primarily for the benefit of the settlors.[2] See Alexandre, "Case Method Restatement of the New Clifford Regulations," 3 Tax L. Rev. 189.

The Supreme Court has long emphasized the test of retention of practical ownership in passing on the tax consequences of intra-family assignment. Soll, Intra-Family Assignments: Attribution and Realization of Income, 6 Tax L. Rev. 435. In the recent case of C.I.R. v. Sunnen, 333 U.S. 591, involving the assignment by the inventor-husband of patent licensing contracts to his wife, the court said, "The crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes," 333 U.S. at 604, and went on to note that "The taxpayer's controlling position in the corporation also permitted him to regulate the amount of royalties payable to his wife." 333 U.S. at 609. In essence the assignment in the present case was effective only to the extent of transferring the single right to receive income. It is now too late to question the well-established proposition that mere assignment of such a right will not suffice to insulate the grantor from tax liability under [§61(a)], and we think like tax results must obtain under [§162(a)]. See Lucas v. Earl; Helvering v. Horst; Helvering v. Eubank, 311 U.S. 122. The recent case of C.I.R. v. Culbertson, 337 U.S. 733, has established the test in the family-partnership field, whether or not there existed as part of the arrangement a "bona fide intent" to have the donee exercise a real part in management, thus giving a final blessing to the doctrine that "true ownership" is decisive in matters of federal taxation. . . .

Since here we find no evidence of a potential exercise of "control and management" on the part of the donee, only of "passive acquiescence to the will of the donor," C.I.R. v. Culbertson, supra, 337 U.S. at 747, 748, since the transaction is in all practical respects a "mere paper reallocation of income among the family members," C.I.R. v. Tower, 327 U.S. [280], 292, and since the husband has remained the actual enjoyer and owner of the property, payments to the wife do not constitute valid business deductions within the statute. . . .

Affirmed.

CHASE, Circuit Judge (dissenting).

Perhaps it would be desirable to protect the revenue by amending [§162(a)] to exclude from the business expense deductions now allowed those which be-

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[1] In the *Skemp* case, 7 Cir., 168 F.2d 598, 599, "the taxpayer . . . did reserve the right to rent all or a part of the building 'at a rental to be determined by the trustee' "; but this does not constitute "beneficial enjoyment" of the property in the *Clifford* sense. Moreover, both leases back were for a term and were not coextensive with the life of the trust.

[2] Here the factor of independent trusteeship is crucial. And it is in this respect that the instant case differs on its facts from the *Skemp* and *Brown* results.

come necessary only because of intrafamily gifts of property used, or to be used, in the business. But that is a matter to be determined by Congress and, until it acts, I think courts are bound to give effect taxwise to gifts which are fully effective otherwise.

There is, I think, some distinction between the disallowance of the royalty and the disallowance of the rent deductions. It is that the transfer of the patent by gift to the wife was a transfer of needed business property already owned by the taxpayer which was intended to, and did, make it necessary to pay her the royalties. The gift of the money, however, which she used together with some of her own to buy the building never owned by the taxpayer was not shown to have been of money which had any connection with the business at all and the net result from the standpoint of the taxpayer and his business was merely a change in landlord. However, as I view this case, it is not necessary to rely upon this distinction.

In respect to the claimed deductions, the decisive factor as the statute is now, is whether the rent and royalty payments were

> required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he had no equity.

[§162(a)(3).] The findings, based on evidence adequately supporting them, show that everything was done to transfer the legal and equitable titles both to the patent and to the building absolutely to the wife, and the ownership she thereby acquired gave her the right to whatever she could get by way of royalties and rents which were, of course, taxable to her as income. And, as [§162(a)(3)] is now so broad that no exception is made because of the way in which business expenses become necessary, i.e., by gift or otherwise, the reasonable royalties and rents the husband paid her were, I think, well within the scope of the statute, being "required" by the license and lease arrangements, and therefore deductible. Skemp v. Commissioner, 7 Cir., 168 F.2d 598; Brown v. Commissioner, 3 Cir., 180 F.2d 926, certiorari denied, 340 U.S. 814. See also Henson v. Commissioner, 5 Cir., 174 F.2d 846. The fact that in the *Skemp* and *Brown* cases the transfers were to independent trustees for the benefit of family members is a distinction without a difference since that bore only on the completeness of the gifts and reasonableness of the royalties and rentals paid, both here shown and found. W. H. Armston Co. v. Commissioner, 5 Cir. 188 F.2d 531, is distinguishable as an instance of a disguised transfer of dividends to a large stockholder of the corporation.

The cases dealing with problems arising under [§61(a)] as to the identity of the taxpayer liable for taxes payable by some one, on which my brothers so much rely, help little, if any, in determining what deductions an identified taxpayer may take under [§162(a)(3)] in computing his net income. Assuming, arguendo, that these cases are relevant,[1] factually they are inapplicable. The only basis pointed out by the majority for applying these cases to the facts before us is that the license of the patent and the lease of the buildings given to the taxpayer left "untouched in all practical reality the husband-donor's effective dominion and control over the properties in question." But whatever control the taxpayer received was the control of a licensee and lessee and was conditioned upon making

[1] The only issue to which these cases could be relevant is whether or not the taxpayer was "required" to pay the royalties and rents as a condition to using the property since that is the test set forth in the statute. In order to be relevant to this issue, and to hold as the majority does, it would seem that one must accept the premise that a donor who retains sufficient control over property transferred by him so as to make any income from that property includible in the donor's gross income under [§61(a)], is not, as matter of law, "required" to pay the donee for its use even though he has entered into a firm, and legally enforceable, obligation so to do.

the payments here claimed to be deductible. It would seem erroneous, therefore, to deny the claimed deduction on this basis.

One other point warrants brief mention. My brothers apparently think that the taxpayer is no longer entitled to any rent deduction because, presumably, he could have used the money he gave his wife to buy the building himself and then he would have had no rent to pay. If he had done so, no doubt he would have been allowed as deductions the maintenance costs, taxes, etc., which must have been included in the rent he paid his wife to make it reasonable over all but the effect of his decision may deprive him of even them. I cannot help but think that my brothers have mistakenly applied the business purpose rule of cases like Gregory v. Helvering, 293 U.S. 465, to a situation where what the taxpayer did was merely to use permissible business judgment as to whether he would increase his business investment or continue to pay reasonable rent.

I would reverse and remand for a judgment for the appellant.

NOTE

Other cases. In addition to the cases cited by the court, see Preston v. Commissioner, 132 F.2d 763 (2d Cir. 1942), and Commissioner v. Park, 113 F.2d 352 (3d Cir. 1940), allowing taxpayers to deduct interest paid on their own bonds which had been transferred by gift, directly or in trust, to members of their families. For an extensive review of the cases, see Woodward v. United States, 106 F. Supp. 14 (N.D. Iowa, 1952).

REV. RUL. 59-110

1959-1 C.B. 45

Advice has been requested whether reasonable wages paid by a father to his children are deductible as ordinary and necessary expenses [under §162(a)] for Federal income tax purposes where the children use the money for part of their own support.

The taxpayer owns and operates a "Drive Inn" restaurant. During the summer months of 1958, he employed his three children to work in the restaurant. Each child worked an average of seven and one-half hours per day. Each child was paid approximately $.75 per hour. Two of the children were minors and the third, who was 21, was a full-time university student during the regular college sessions. All the money earned by the children was expended for clothing, education and miscellaneous personal expenditures. . . .

Reasonable wages paid by a father to his child for personal services actually rendered as a bona fide employee in the conduct of a trade or business have been held deductible as ordinary and necessary expenses. See I.T. 3767, C.B. 1945, 101; Estate of K. Threefoot v. Commissioner, 9 BTA 499, acquiescence, C.B. VII-1, 31 (1928). The fact that there may be a legal obligation to support the person to whom the wages are paid and that such person utilizes the wages for his own support is not determinative of their deductibility as a business expense by the employer. These circumstances merely subject the relationship to a closer scrutiny to determine whether there is in fact a bona fide employment situation.*

* I.T. 3812, 1946-2 C.B. 29: "In determining whether there is in fact such a relationship, consideration must be given to whether the father is dealing with his minor child, for the purpose of employment, as he would deal with a stranger under the same circumstances. Thus, there should be a satisfactory showing by the father that the usual conditions of employment, such as duties, hours of work, amount of wages, and time of payment of wages, had been agreed upon to the same extent as they would have been had the father been engaging the services of a stranger. If wages are paid pursuant to an arrangement in the guise of an employer-employee relationship, entered into either before or after the services are performed, a claimed deduction for wages paid will not be allowed." — Ed.

It is the nature of the wages as an ordinary and necessary expense in the operation of a business, as well as the character of the relationship between the parties as that of employer and employee, which are controlling for purposes of the deduction of wages paid as a business expense.

The facts in this case show that actual services were rendered by each of the taxpayer's children as a bona fide employee in the operation of the taxpayer's business, and that the compensation paid each child for such service was reasonable and constituted an ordinary and necessary expense of carrying on such business. Hence, such wage payments are deductible from gross income as provided in section 162 of the Code. To hold otherwise would be tantamount to penalizing the father for employing his own children inasmuch as the deduction would be allowable if he had employed someone else's children under the same circumstances.

Accordingly, it is held that reasonable wages paid by a father to his children for services rendered by them as his employees in his trade or business are deductible as ordinary and necessary business expenses for Federal income tax purposes even though the children use the wages for part of their own support. For the circumstances under which a parent may also claim a dependency exemption by reason of his contribution to the support of such children, see sections 151 and 152 of the Code.

I.T. 3812, C.B. 1946-2, 29, held that the value of meals and lodging furnished by a father to his unemancipated minor child is not includible, for Federal income tax purposes, in the gross income of the child and is not deductible as wages in computing the net income of the father, even though an employer-employee relationship exists between them. It also held that if the father takes the child's earnings and utilizes them for his own purposes, or if the father requires the child to purchase his own clothing or other necessities which the father is obligated to furnish, the deduction of the child's earnings as a business expense should be disallowed.

I.T. 3812, C.B. 1946-2, 29, is hereby modified to the extent that it may be construed to mean that regardless of the bona fides of an employment relationship between a parent and a child, the deductibility of wages paid as an ordinary and necessary business expense shall be conditioned upon the use to which the child puts such wages.

NOTE

1. *Dependency exemption.* How will the father's right to a $600 dependency exemption for his children be affected by his payment of wages to them?

2. *Child's earnings.* What is the purpose of §73, providing that amounts "received in respect of the services of a child" are includible in the child's gross income (rather than the parent's), even though the amounts are not received by the child? If the child's earnings are received by the parent, when are expenditures for supporting the child "attributable" to the child's earnings so as to be treated as made by the child by virtue of §73(b)? See Dick v. United States, 218 F. Supp. 839 (E.D. Wis. 1963) (expenses of supporting child defrayed with child's earnings; held, these amounts are not attributable to father in determining whether he provided more than one-half of support for purposes of dependency exemption).

McWILLIAMS v. COMMISSIONER

331 U.S. 694 (1947)

MR. CHIEF JUSTICE VINSON delivered the opinion of the Court.

The facts of these cases are not in dispute. John P. McWilliams, petitioner in

No. 945, had for a number of years managed the large independent estate of his wife, petitioner in No. 947, as well as his own. On several occasions in 1940 and 1941 he ordered his broker to sell certain stock for the account of one of the two, and to buy the same number of shares of the same stock for the other, at as nearly the same price as possible. He told the broker that his purpose was to establish tax losses. On each occasion the sale and purchase were promptly negotiated through the Stock Exchange, and the identity of the persons buying from the selling spouse and of the persons selling to the buying spouse was never known. Invariably, however, the buying spouse received stock certificates different from those which the other had sold. Petitioners filed separate income tax returns for these years, and claimed the losses which he or she sustained on the sales as deductions from gross income. . . .

Petitioners contend that Congress could not have intended [by §267(a)(1)] to disallow losses on transactions like those described above, which, having been made through a public market, were undoubtedly bona fide sales, both in the sense that title to property was actually transferred, and also in the sense that a fair consideration was paid in exchange. They contend that the disallowance of such losses would amount, pro tanto, to treating husband and wife as a single individual for tax purposes.

In support of this contention, they call our attention to the pre-1934 rule, which applied to all sales regardless of the relationship of seller and buyer, and made the deductibility of the resultant loss turn on the "good faith" of the sale, i.e., whether the seller actually parted with title and control. They point out that in the case of the usual intra-family sale, the evidence material to this issue was peculiarly within the knowledge and even the control of the taxpayer and those amenable to his wishes, and inaccessible to the Government. They maintain that the only purpose of the provisions of the 1934 and 1937 Revenue Acts — the forerunners of [§267(a)(1)] — was to overcome these evidentiary difficulties by disallowing losses on such sales irrespective of good faith. It seems to be petitioners' belief that the evidentiary difficulties so contemplated were only those relating to proof of the parties' observance of the formalities of a sale and of the fairness of the price, and consequently that the legislative remedy applied only to sales made immediately from one member of a family to another, or mediately through a controlled intermediary.

We are not persuaded that Congress had so limited an appreciation of this type of tax avoidance problem. Even assuming that the problem was thought to arise solely out of the taxpayer's inherent advantage in a contest concerning the good or bad faith of an intra-family sale, deception could obviously be practiced by a buying spouse's agreement or tacit readiness to hold the property sold at the disposal of a selling spouse, rather more easily than by a pretense of a sale where none actually occurred, or by an unfair price. The difficulty of determining the finality of an intra-family transfer was one with which the courts wrestled under the pre-1934 law, and which Congress undoubtedly meant to overcome by enacting the provisions of [§267(a)(1)].

It is clear, however, that this difficulty is one which arises out of the close relationship of the parties, and would be met whenever, by prearrangement, one spouse sells and another buys the same property at a common price regardless of the mechanics of the transaction. Indeed, if the property is fungible, the possibility that a sale and purchase may be rendered nugatory by the buying spouse's agreement to hold for the benefit of the selling spouse, and the difficulty of proving that fact against the taxpayer, are equally great when the units of the property which the one buys are not the identical units which the other sells.

Securities transactions have been the most common vehicle for the creation of

intra-family losses. Even if we should accept petitioners' premise that the only purpose of [§267(a)(1)] was to meet an evidentiary problem, we could agree that Congress did not mean to reach the transactions in this case only if we thought it completely indifferent to the effectuality of its solution.

Moreover, we think the evidentiary problem was not the only one which Congress intended to meet. Section [§267(a)(1)] states an absolute prohibition — not a presumption — against the allowance of losses on any sales between the members of certain designated groups. The one common characteristic of these groups is that their members, although distinct legal entities, generally have a near-identity of economic interests. It is a fair inference that even legally genuine intra-group transfers were not thought to result, usually, in economically genuine realizations of loss, and acordingly that Congress did not deem them to be appropriate occasions for the allowance of deductions.

The pertinent legislative history lends support to this inference. The Congressional Committees, in reporting the provisions enacted in 1934, merely stated that "the practice of creating losses through transactions between members of a family and close corporations has been frequently utilized for avoiding the income tax," and that these provisions were proposed to "deny losses to be taken in the case of [such] sales" and "to close this loophole of tax avoidance." Similar language was used in reporting the 1937 provisions. Chairman Doughton of the Ways and Means Committee, in explaining the 1937 provisions to the House, spoke of "the artificial taking and establishment of losses where property was shuffled back and forth between various legal entities owned by the same persons or person," and stated that "these transactions seem to occur at moments remarkably opportune to the real party in interest in reducing his tax liability but, at the same time allowing him to keep substantial control of the assets being traded or exchanged."

We conclude that the purpose of [§267(a)(1)] was to put an end to the right of taxpayers to choose, by intra-family transfers and other designated devices, their own time for realizing tax losses on investments which, for most practical purposes, are continued uninterrupted.

We are clear as to this purpose, too, that its effectuation obviously had to be made independent of the manner in which an intra-group transfer was accomplished. Congress, with such purpose in mind, could not have intended to include within the scope of [§267(a)(1)] only simple transfers made directly or through a dummy, or to exclude transfers of securities effected through the medium of the Stock Exchange, unless it wanted to leave a loophole almost as large as the one it had set out to close.

Petitioners suggest that Congress, if it truly intended to disallow losses on intra-family transactions through the market, would probably have done so by an amendment to the wash sales provisions,* making them applicable where the seller and buyer were members of the same family, as well as where they were one and the same individual. This extension of the wash sales provisions, however, would bar only one particular means of accomplishing the evil at which [§267(a)(1)] was aimed, and the necessity for a comprehensive remedy would have remained.

Nor can we agree that Congress' omission from [§267(a)(1)] of any prescribed time interval, comparable in function to that in the wash sales provisions, indicates that [§267(a)(1)] was not intended to apply to intra-family transfers through the Exchange. Petitioners' argument is predicated on the difficulty which courts may have in determining whether the elapse of certain periods of time between

* Section 1091 of the 1954 Code, which re-enacts §§118 and 113(a)(10) of the 1939 Code. — Ed.

one spouse's sale and the other's purchase of like securities on the Exchange is of great enough importance in itself to break the continuity of the investment and make [§267(a)(1)] inapplicable.

Precisely the same difficulty may arise, however, in the case of an intra-family transfer through an individual intermediary, who, by pre-arrangement, buys from one spouse at the market price and a short time later sells the identical certificates to the other at the price prevailing at the time of sale. The omission of a prescribed time interval negates the applicability of [§267(a)(1)] to the former type of transfer no more than it does to the latter. But if we should hold that it negated both, we would have converted the section into a mere trap for the unwary.[1]

Petitioners also urge that, whatever may have been Congress' intent, its designation in [§267(a)(1)] of sales "between" members of a family is not adequate to comprehend the transactions in this case, which consisted only of a sale of stock by one of the petitioners to an unknown stranger, and the purchase of different certificates of stock by the other petitioner, presumably from another stranger.

We can understand how this phraseology, if construed literally and out of context, might be thought to mean only direct intra-family transfers. But petitioners concede that the express statutory reference to sales made "directly or indirectly" precludes that construction. Moreover, we can discover in this language no implication whatsoever that an indirect intra-family sale of fungibles is outside the statute unless the units sold by one spouse and those bought by the other are identical. Indeed, if we accepted petitioners' construction of the statute, we think we would be reading into it a crippling exception which is not there. . . .

Affirmed.

MR. JUSTICE BURTON took no part in the consideration or decision of these cases.

NOTE

1. *Scope of §267(a)(1).* Is the husband's nondeductible loss to be taken into account when the wife later sells the shares? See §267(d), enacted in 1954; and note that the adjustment thus allowed is less comprehensive than is allowed to the taxpayer who engages in a "wash" sale under §1091.

Section 267 disallows losses; it does not exempt gain. Suppose A buys a vacant city lot for $5000 and during a boom buys an identical adjacent lot for $15,000. Later he sells the lots to his wife for the price of $10,000 each, the market value at that time. For tax purposes, does he break even or have a gain of $5000? See Morris Investment Co. v. Commissioner, 156 F.2d 748 (3d Cir. 1946).

Section 267 is not exhaustive; loss may be disallowed if the transaction is devoid of economic reality even though the vendee is not in the prohibited group. Crown Cork International Corp. v. Commissioner, 4 T.C. 19 (1944), aff'd per curiam, 149 F.2d 968 (3d Cir. 1945); cf. Higgins v. Smith (cited and summarized in the *Laughton* case, supra page 401), disallowing loss on a sale by a shareholder to his wholly owned corporation for a year before the enactment of §267(a)(1)); Dupont v. Commissioner, 118 F.2d 544 (3d Cir. 1941).

See Anthoine, Transactions Between Related Taxpayers, 1956 Tulane Tax Inst. 269.

2. *Section 267's concept of "related taxpayers."* The blanket disallowance of losses incurred in sales between related taxpayers reaches not only sales between husband and

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[1] We have noted petitioners' suggestion that a taxpayer is assured, under the wash sales provisions, of the right to deduct the loss incurred on a sale of securities, even though he himself buys similar securities thirty-one days later; and that he should certainly not be precluded by [§267(a)(1)] from claiming a similar loss if the taxpayer's spouse, instead of the taxpayer, makes the purchase under the same circumstances. We do not feel impelled to comment on these propositions, however, in a case in which the sale and purchase were practically simultaneous and the net considerations received by one spouse and that paid by the other differed only in the amount of brokers' commissions and excise taxes.

wife, but transactions between a wide range of other related individuals and entities. The concept of "related taxpayers" requires a statutory determination of what members of a family (siblings? cousins? in-laws?) are to be included, of what entities are to be pierced (trusts? estates? partnerships?) and, if the corporate veil is to be pierced, what shareholders (in terms of voting power, number and value of shares, etc.) shall be taken into account. It is also necessary to decide whether stock owned constructively by one individual shall be attributed from him to another person (e.g., if Jones is treated as owning all of the stock of a corporation because it is actually owned by his son, so that Jones could not deduct a loss on a sale of property to the corporation, is Jones' brother related to the corporation so that he too cannot deduct a loss on a sale to it?).

There are many places in the Code where a concept of "relatedness" is employed, ordinarily because of a fear that transactions between related taxpayers may not have the same effect in real life that they have on paper, but there is no uniform definition of the concept. The three principal definitions are to be found in §267, §318 (applicable to many corporate transactions), and §544 (applicable in defining the term "personal holding company"); many other provisions use one of these prototypes as a base, but impose their own refinements. In addition to these variations in the degree of relationship required, there are differences in the number of constructive links to be taken into account, in the direction in which attribution of stock is to run, etc. See Reilly, An Approach to the Simplification and Standardization of the Concepts "The Family," "Related Parties," "Control," and "Attribution of Ownership," 15 Tax L. Rev. 253 (1960); Ringel, Surrey, and Warren, Attribution of Stock Ownership in the Internal Revenue Code, 72 Harv. L. Rev. 209 (1958); Advisory Group Recommendations on Subchapter C, House Committee on Ways and Means, 86th Cong., 1st sess. (1959) 610-613.

SECTION D. INCOME-SPLITTING AMONG CORPORATIONS

Section 482, permitting the Treasury to allocate income, deductions, etc. among related taxpayers to prevent tax evasion or to reflect income clearly, is a re-enactment of §45 of the 1939 Code.

Section 269, disallowing deductions, credits, etc. in certain controlled corporation transactions if the principal purpose is tax avoidance, is based on §129 of the 1939 Code.

Section 1551, disallowing the surtax exemption and accumulated earnings credit, when property is transferred to a controlled corporation and the corporation fails to establish that tax avoidance was not a major purpose, is based on §15(c) of the 1939 Code, with important changes in 1964.

Sections 1561-1563, relating to the surtax exemptions of affiliated corporations, were enacted in 1964.

Since corporate income tax rates are not as steeply progressive as the individual income tax rates, there is less to be gained by the splitting of income among affiliated corporations. For 1964, the corporation must pay a normal tax of 22 per cent and, on its income in excess of $25,000, a surtax of 28 per cent. Section 11(b) and §11(c). (The normal tax and surtax are imposed on the same base, except that "partially tax-exempt interest" is subject to the surtax but not to the normal tax.) If business income of $50,000 can be divided equally between two corporations, the additional surtax exemption of $25,000 will save the group $7000 in taxes, i.e., 28 per cent of $25,000. If a business income of $1,000,000 is similarly divided between two corporations, precisely the same saving, $7000, will result. Splitting $1,000,000 of income equally among forty corporations, however, would result in a saving of $273,000, since forty surtax exemptions, instead of only one, would be allowed.

With the reduction of the surtax rate to 26 per cent in 1965, the tax savings

from an additional surtax exemption will become $6500 (26 per cent of $25,000), instead of $7000.

Corporate income can often be split by having separate corporations carry on different branches of an enterprise: a factory may be owned by a real estate corporation, which leases it to a second corporation engaged in manufacturing; the latter may buy its supplies from a third corporation and in turn sell its manufactured goods to one or more sales corporations, all corporations being under common control. A combination of corporate and individual or partnership activity is also possible. Within limits, a division of income by such means is possible. The student should examine §482, authorizing the Commissioner "to distribute, apportion, or allocate gross income, deductions, credits or allowances" among any two or more taxable entities that are under common ownership or control so as "clearly to reflect the income" of such entities. Section 482 has been the Commissioner's principal weapon where transactions between two related business units are manipulated for tax purposes, e.g., sales at artificial prices to increase the income or losses of one of the entities in an arbitrary fashion, but cases like Lucas v. Earl, *Clifford*, and *Horst* have also proved to have much vitality in the area of corporate income-splitting. As will be seen (infra pages 427-428), the government may also invoke a number of statutory provisions: §269 (dating from 1943); §1551 (originally enacted in 1951, but extensively revised in 1964); and §§1561-1563 (enacted in 1964).

While primary attention is now being directed to income-splitting by the use of subsidiary and affiliated corporations, the student should recognize that sometimes an enterprise that is carried on through a complex of separate corporations may prefer to disregard all intra-family transactions and report its income on a consolidated basis. A simple illustration may make the problem clear. Assume Corporation A owns both B and C, that B manufactures widgets and sells them at current wholesale prices to C, which sells them to the public. B and C both distribute part of their profits as dividends to A. In any given year, B may be operating at a profit while C is operating at a loss; and some or all of the dividends paid by B to A may represent intra-company, rather than "real," profits. By reason of the dividends-received deduction of §243(a) (infra p. 606), A would ordinarily be taxed on only 15 per cent of the dividends received from B, but even this amount may exceed the "real" profits of the whole group.

By filing a consolidated return, as authorized by §1501, the corporate group will be taxed only on the profits represented by its transactions with the outside world. In effect, C's loss is offset against B's gain, and the dividends paid to A by B and C are disregarded. The group is treated as a single entity, so that only one surtax exemption is allowed; with this exception, however, the tax rate is the same on a consolidated return as on a separate return. (Before 1964, the surtax was increased by two percentage points for taxpayers filing a consolidated return.) Once a consolidated return has been filed, the group must continue to report on a consolidated basis, unless (1) a new corporation (other than one organized or created by a member of the affiliated group) becomes a member of the group, (2) the Commissioner consents to the use of separate returns, or (3) the statute or Regulations are amended so as to make consolidated returns less advantageous to affiliated groups as a class. See Hellerstein, Consolidated Federal Income Tax Returns, 5 Amer. U. Tax Inst. Lectures 415 (1953); Blitman, Consolidated Returns in the Federal Tax System, 8 Nat. Tax J. 260 (1955); Cuddihy, Consolidated Returns, 16 N.Y.U. Inst. on Fed. Taxation 351 (1958).

COMMISSIONER v. CHELSEA PRODUCTS, INC.

197 F.2d 620 (3d Cir. 1952)

Before McLaughlin, Staley and Hastie, Circuit Judges.

Staley, Circuit Judge.

The Commissioner of Internal Revenue has petitioned for a review of two decisions of the Tax Court. The principal issue presented is whether [§482] . . . authorizes the Commissioner to combine the net income of three corporations with that of taxpayer where all are owned by the same interests. We are in accord with the Tax Court's conclusion that [§482] was erroneously applied.

Between 1941 and 1944, taxpayer was engaged in the manufacture and sale of fans and blowers under the name of Chelsea Fan & Blower Co., Inc. During this period the sole stockholders, officers, and directors of taxpayer were William J. Lohman, Sr., who held 50% of the common stock outstanding, and his two sons, Eugene W. and William J., Jr., each of whom held 25%.

In 1944 the three Lohmans, after consultations with their attorney, decided to separate taxpayer's manufacturing functions from its sales. The new plan was carried out by forming a sales corporation in each of three states: Missouri, Georgia, and New Jersey. These new corporations bore the respective names Chelsea Fan and Blower Company of Missouri, Chelsea Fan & Blower Company of Georgia, and Chelsea Fan and Blower Co., Inc. Each of the sales companies issued 1200 shares of stock at $1 a share, which was subscribed to in equal amounts by each of the three Lohmans. As in the case of taxpayer, the three Lohmans constituted the Board of Directors of each of the sales companies during the taxable years involved. At the same time, the taxpayer changed its name to Chelsea Products, Incorporated, and therafter confined its activities principally to manufacturing.

Prior to the creation of the new corporate structure in 1944, taxpayer had sold its products through its officers and through "manufacturer's agents." Taxpayer had entered into contractual arrangements with these agents whereby they were paid commissions of about 10% on sales. After July 11, 1944, taxpayer no longer employed these manufacturer's agents. On that date the sales companies were designated exclusive agents, each company being assigned a different area of the country, and they in turn proceeded to employ sales agents. The arrangements between taxpayer and the sales companies were formalized by written agreements entered into between taxpayer and each sales company. These agreements, signed by William J. Lohman as president of taxpayer and Eugene W. Lohman as vice president of the sales companies, provide that each sales company is to "employ a sufficient number of salesmen to properly canvass its territory" and is to be charged the list price less 50% and 25%. The former discount was the standard one given by those in the industry to wholesale jobbers and was passed on to the wholesale jobbers who bought the products. The 25% discount, the Tax Court found, includes the 10% commission normally paid to the agent, thus leaving 15% for the operation of the business of the sales companies.

Although the Missouri and Georgia companies had mailing addresses in their respective states of incorporation, neither had an office there. Each of the sales companies maintained its office in New Jersey at 1206 South Grove Street, Irvington — the same address which had been occupied by taxpayer. Each of the companies had separate books and records and separate bank accounts. The records of the sales companies were kept by the same bookkeeper who kept taxpayer's books and were audited by an outside accounting firm.

During the taxable years involved, all the fans and blowers sold by the sales companies were manufactured by taxpayer. A sales agent, upon receiving an order, would send it to Irvington, N.J., to the sales company which employed him. The order was then turned over to taxpayer which shipped the merchandise directly to the customer and invoiced the sales company. The latter, in turn, submitted an invoice to the customer and received payment from him.

The business reasons which prompted the organization of the sales companies are set forth in the record. The attorney whom the Lohmans consulted in 1944 testified that he had advised them that taxpayer's tort liability arising from accidents in the use of the fans could thereby be "minimized." The record also reveals that the Lohmans had intended that the sales companies establish assembly plants in several states in order to reduce freight costs. Further, the Lohmans believed that sales, especially in the South, would be increased if promoted by a local firm.*

The Commissioner determined that there was a deficiency of $110.58 in taxpayer's income tax liability and $37,091.85 in its excess profits tax liability for the year 1944. He also determined that there was a deficiency of $165.62 in its income tax liability and $25,519.13 in its excess profits tax liability for the year 1945. In arriving at these deficiencies, the Commissioner allocated the net income of the three sales companies to that of taxpayer. The latter then sought a redetermination before the Tax Court. The Tax Court found that each sales company was a business enterprise separate and distinct from taxpayer and that no part of the income of the sales companies constituted income to it. Moreover, that Court determined that the principal purpose for the organization of the sales companies was to carry on business and not to aid taxpayer in evading or avoiding Federal income or excess profits taxes. The Tax Court, five judges dissenting, held that the Commissioner's action was not authorized.

The Commissioner asserts that he acted within the broad discretionary power conferred upon him by [§482] which . . . has been a part of our Revenue Laws since 1928. It is in some sense an offspring of Section 240(f) of the Revenue Act of 1926, which gave the Commissioner the right to consolidate the accounts of business controlled by the same interests where he finds it necessary to make an accurate distribution of profits and deductions. Section 240(f) was a part of the Consolidated Returns section of the 1926 Act. In drafting the new [§482], important changes were made and, significantly enough, the offspring became a new section, separate and apart from the Consolidated Returns section.

Section [482] grants to the Commissioner power to allocate "gross income, deductions, credits, or allowances." There is no mention of authority to disregard completely the corporate entity by combining the net income of controlled corporations. The plain language of [§482] must prevail. . . . The Report of the House Ways and Means Committee states that the evil for which [§482] was designed was the arbitrary shifting of profits from one corporation to another by such devices as fictitious sales. House Rep. No. 2, 70th Cong., 1st Sess., p. 16. . . . Whenever the lack of an arm's length relationship produces a different economic result from that which would ensue in the case of two uncontrolled taxpayers dealing at arm's length, the Commissioner is authorized to allocate gross income and deductions.

* In Napier Furniture Co., Inc. v. Commissioner, ¶63,124 P-H Memo T.C., the taxpayer asserted that an Alabama corporation had been organized to avoid prejudice against a "Yankee" firm. On finding that nothing had been done to communicate to Southern customers that the corporation was from Dixie rather than from the North, however, the court concluded that the alleged reason for a separate entity had not been established. — Ed.

Section [482], based upon a recognition of the various corporate entities, merely allows the Commissioner to prevent distortions in income between controlled corporations. In fact, the Treasury Regulation itself states that [§482] is

> not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions . . . as would produce a result equivalent to a computation of consolidated taxable income. . . . [Regs. §1.482-1(b)(3).]

The Commissioner, in disregarding the corporate entities of the sales companies and lumping together all net incomes, has proceeded beyond his statutory bounds.[1]

[The court also held that the deficiency notices were defective in that they failed to give the taxpayer notice of the Commissioner's reliance on §482. Finally, the court suggested that an attempt by the Commissioner to rely on §269 (infra page 428) had come too late, but that this procedural issue need not be decided because "the Tax Court has found as a fact that the principal purpose of the organization of the sales companies was to carry on business and not to aid in the evasion or avoidance of Federal income or excess profits taxes."]

For the above reasons, the decisions of the Tax Court will be affirmed.

TWIN OAKS CO. v. COMMISSIONER

183 F.2d 385 (9th Cir. 1950)

Before MATHEWS, BONE and LINDLEY, Circuit Judges.

LINDLEY, Circuit Judge.

This is a petition to review a decision of the United States Tax Court sustaining the assessment of income taxes against the corporate petitioner for the years 1941-44 inclusive.

Prior to January, 1941, the Petitioner had, for many years, been engaged in the purchase and sale of builders' materials. During all this period the business had

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[1] The Court of Appeals for the Second Circuit has recently handed down its decision in Advance Machinery Exchange, Inc. v. Commissioner, 2 Cir., 196 F.2d 1006. The taxpayer there was organized by one Blachman to deal in used machinery. Subsequently, two corporations (which we denominate A and B) were formed to engage in the same business and Blachman proceeded to engage in the same business individually. All four businesses were controlled by Blachman and his son. All the entities conducted their businesses at the same office and all used the identical employees and equipment. Each enterprise had many customers in common. In contrast to the instant case, *there was no separation of business functions* as among the four enterprises. The Tax Court's conclusion is well expressed in the following statement in its opinion: "All four businesses were controlled by J. Blachman and Seymour Blachman, father and son. The two operated the business and kept the books and records of all four businesses in such a way that the net profit of each could be manipulated as they saw fit, and, in general, so conducted the business that *it is impossible to determine where the activities of one or the other begin and end.*" (Italics supplied.)

The Commissioner allocated the net income of Corporation A, Corporation B, and Blachman individually to the taxpayer, relying on both [§61(a) and §482] of the Internal Revenue Code. The Tax Court, 8 T.C.M. 84 (1949), held that the Commissioner's determination was proper under the broad scope of [§61(a)] but was silent on the applicability of [§482]. The Tax Court was clearly of the opinion that the three enterprises other than taxpayer were mere shams. The Tax Court concluded with the following words: *"In reality, therefore, there is but one taxable entity, the petitioner, and all of the income of the business is attributable to it."* (Italics supplied.) The finding is thus in marked contrast with the Tax Court's finding in the case at bar that each of the sales companies was a business enterprise separate from the taxpayer and that the principal purpose for their organization was to carry on business.

In affirming the decision of the Tax Court, the Court of Appeals for the Second Circuit relied on [§482] rather than [§61(a)]. We consider the Court's observation with respect to [§482] to be essentially dicta, for, since the Tax Court had determined that there was but one taxable entity, all the net income was necessarily taxable to taxpayer under [§61(a)].

been managed by Rogers, who, with 473 shares of the corporate stock, was the corporation's principal stockholder, and Scharpf, who held 35.3 shares and whose wife owned the remaining 437.7 shares. In January, 1941, after the corporation had for some time realized unsatisfactory profits, pursuant to a plan suggested by Scharpf and, after some opposition, agreed to by Rogers, the latter and his wife and Scharpf and his wife executed a partnership agreement whereby the four, as equal partners, were to take over the business of the corporation, purchasing its operating assets and leasing from it the real estate on which the business had been and was then being conducted. The two men were to continue to manage the business; each was to receive an annual salary of $6,600 in addition to one-fourth of the partnership profits; their wives were to furnish lesser services for which they were to receive salaries of $300 per annum each.

Petitioner, in consideration of the assumption by the partnership of the corporation's accounts payable and of the partnership's promissory note in an amount which, added to the liabilities assumed, equaled the book value of the petitioner's assets other than real estate, transferred to the partnership all its assets except the premises on which the business had been and was thereafter to be conducted, which land it leased to the partnership for an annual rental of $3000. Each of the four partners contributed $2000 in additional capital. Petitioner caused its corporate name to be changed from Twin Oaks Builders Supply Company to Twin Oaks Company, and the partnership, after registration with proper public authorities, engaged in business under the name by which petitioner had formerly been known. The corporation and the partnership thereafter maintained different and separate sets of books, records and bank accounts.

In the years 1941-44, petitioner's income, duly reported, included only (1) the rent received from the partnership under the lease, (2) the interest paid by the partnership on its note, and (3) a few petty miscellaneous items. The Commissioner asserted tax deficiencies against the corporation on the theory that the partnership had been created solely as a device improperly to effectuate reallocation of income among family groups to defeat taxes and, hence, that the profits of the partnership, reported in the individual returns filed by Rogers and Scharpf and their wives, were properly taxable to petitioner. A single-judge Tax Court sustained the deficiency assessments, agreeing with the Commissioner that the creation of the partnership and the transfer to it of petitioner's operating assets had been "forms without substance" which were not entitled to recognition, in so far as taxes were concerned.

It is, as the Tax Court observed, well settled that a taxpayer is free to adopt such legal organization for the conduct of his affairs as he may choose; he may convert from the corporate method to the partnership method of doing business and, though his motive in so doing be to reduce taxes, the conversion must be accorded recognition unless it is such a sham, such a change in form only, without substance, as to require that it be disregarded for tax purposes. Helvering v. Clifford, 309 U.S. 331. It seems clear to us, however, that the Tax Court, in its characterization of the change in business structure involved in the instant case as a sham and a mere form without substance, has, in effect denied the taxpayers the legal right to conduct their business affairs through a medium of their own choice.

There can be no doubt that it was the intent of the parties that the partnership should thereafter conduct the supply business which, prior to the formation of the partnership, had been conducted by petitioner; that the partnership was actually formed; that petitioner's stockholders were, as members of the partnership, subjected to unlimited personal liability not only for the old corporate debts but also for any which might grow out of the operation of the business thereafter by

the partnership, in place of the limited liability to which they had previously been subject, and that the profits of the business were not thereafter distributed among the partners in proportion to their respective holdings of stock in the corporate petitioner. These changes, all made without thought of or intent to achieve tax advantages, were, we think, far more than mere changes in form. The Tax Court felt that the fact that profits were distributed in a different manner and in different proportions, but to the same people, indicated that the changes were formal only. The logic of this position escapes us, for it ignores the reality of the conversion from corporate to partnership operation of the business and tends in no way to show that the corporation, rather than the partnership, earned the income.

It seems obvious that if petitioner's affairs had been completely liquidated, the income in question would necessarily have been regarded as earned by the partnership. The mere fact that the parties stopped one step short of liquidation, i.e., kept the corporation alive for the sole purpose of holding title to the real estate, while selling and transferring the operating business itself to the partnership, does not, we believe, detract from the reality or substance of what was done or require that all the income of the business be taxed to petitioner. As a matter of fact, the decision of the Tax Court itself, in such cases as Seminole Flavor Co., 4 T.C. 1215; Buffalo Meter Co., 10 T.C. 83; and Miles-Conley Co., 10 T.C. 754, would seem to impel a decision that the partnership was entitled to full recognition for tax purposes even though the corporation continued to exist and to function in a rather close relationship with it. The Tax Court sought to distinguish these cases by saying that the businesses involved therein were capable of being broken down into distinct divisions, whereas the builders supply business was "unitary in character," but it certainly could be and was easily separated from the real estate and was thereafter conducted solely by the partnership.

We conclude that the Tax Court erred in sustaining the Commissioner's deficiency assessments against petitioner. The decision is reversed.

JAMES REALTY CO. v. UNITED STATES

280 F.2d 394 (8th Cir. 1960)

Before GARDNER, WOODROUGH, and BLACKMUN, Circuit Judges.

WOODROUGH, Circuit Judge.

The taxpayer James Realty Company, a corporation, prosecutes this appeal from that part of a judgment which denies it recovery of refund of its payment of deficiency assessed for corporate surtax and excess profits tax for its taxable year ending November 30, 1953. It received and made return of income of $24,699.05 for the period and claimed deduction under the $25,000 corporate surtax exemption and $25,000 minimum excess profits tax credit* . . .

The Commissioner disallowed the deduction and credit on the ground that the corporation was created solely for the purpose of tax avoidance and was deprived of the right to the exemption and credit by [§269(a) and §1551]. The resulting deficiency was paid and this action followed. After partial trial before a jury, the issues were submitted to the Court by stipulation of the parties. The opinion of the Court is published at 176 F. Supp. 306.

* The "$25,000 corporate surtax exemption" is a shorthand reference to the fact that the first $25,000 of corporate income is taxed at only 22 per cent, while amounts above $25,000 are subject to both the normal tax of 22 per cent and the surtax of 28 (or, after 1965, 26) per cent. The "$25,000 minimum excess profits tax credit" refers to the fact that the excess profits tax (in force during World War II and 1950-1953) was not applicable to the first $25,000 of corporate income. — ED.

It appeared on the trial that Adolph Fine organized Adolph Fine, Inc. in 1944 to engage in the construction business and later in 1949 he incorporated Fine Realty, Inc., whose principal activity was to sell homes built by Adolph Fine, Inc. Both of these corporations were controlled and managed by Adolph Fine and his wife, Mildred, who owned the stock of such corporations individually or in trust for their children. Also, at all times pertinent hereto, Adolph Fine was president and treasurer, Mildred Fine was vice president and secretary, and June Myslajek was assistant secretary to Adolph Fine, Inc.; Mildred Fine was president and treasurer, M. L. Grossman was vice president, and June Myslajek was secretary of Fine Realty, Inc.

In 1952, Adolph Fine, as an individual, owned certain undeveloped land located in the village of St. Louis Park, Minnesota, which he caused to be subdivided and platted for the purpose of home development, and named it the Jeffrey, James Fine Addition to St. Louis Park.

On November 20, 1952, Adolph Fine caused the taxpayer, James Realty Company, to be organized with an initial authorized capital of $25,000, consisting of ten shares of Class A common stock at a par value of $100 (voting) and two hundred and forty shares of Class B common stock at a par value of $100 (non-voting). According to the articles of incorporation, the purpose of the corporation was, among other things:

> To acquire, improve, and develop real property; to erect dwellings of all kinds and to sell, or rent the same; also to acquire, by purchase, lease, or otherwise, and to take, own, hold, sell, exchange, transfer, lease, repair, maintain, improve, mortgage, or in any other manner deal in and with real property . . .

On November 24, 1952, Adolph Fine conveyed eighteen of the lots in the Jeffrey, James Fine Addition to the taxpayer corporation in exchange for two shares of its Class A common stock and thirty-four shares of its Class B common stock. The value of the lots in terms of the thirty-six shares was $200 per lot or $3,600. On the same day, Adolph Fine transferred seventeen shares of the Class B stock to his wife Mildred in trust for their sons Jeffrey and James.

Also on November 24, 1952, the taxpayer corporation, acting through its president, Adolph Fine, entered into two written contracts. The first was an agreement with Adolph Fine, Inc., by which that corporation would construct houses on the lots owned by the taxpayer James Realty Co., at cost plus 12½%. By the terms of a second contract, with Fine Realty, Inc., that corporation was made the exclusive selling agent of the homes to be constructed for taxpayer by Adolph Fine, Inc. Sales commissions were to be from 5% to 7½% depending upon financing arrangements and costs.

In August, 1953, taxpayer purchased thirty-six lots located in the neighboring West Tonka Hills Addition from Fine Realty, Inc. at a price of $650 per lot, or a total price of $23,000.

During its fiscal year ended November 30, 1953, when taxpaper reported taxable income in the amount of $24,699.05, only $355.56 of this amount was attributable to the sale of lots purchased from Fine Realty, Inc., while the remaining income was derived from sales of houses built on lots acquired from Adolph Fine.

Taxpayer was one of nine development companies formed by Adolph Fine between 1950 and 1954. All of them occupied offices owned by Adolph Fine, Inc., and were supplied with bookkeeping services by the same personnel who kept the books of Adolph Fine, Inc. . . .

The determination by the District Court that Mr. Fine organized and acquired control of the taxpayer corporation for the principal purpose of tax avoidance was a finding of fact which is conclusive on this appeal if supported by substan-

tial evidence and not clearly erroneous. Although Mr. Fine testified that in forming the taxpayer and eight other corporations he had in mind the two purposes of implementing his estate plan and of spreading and minimizing risks of loss from business reversal or tort liability and that tax saving was not the principal purpose, he admitted that he was aware of the tax consequences of the multiple corporate set up and testimony of his secretary and bookkeeper was to the effect that "she made adjusting entries" in the books of Adolph Fine, Inc., Fine Realty, Inc., and the development companies including taxpayer; that "a great deal of consideration was given to taxes" by Mr. Fine and his accountants and that "we were very careful to keep the figures under $25,000.00, the profit figures." An office memorandum from Mr. Fine made in 1957 concerning "the land status" of "the following companies" "to determine what company should own and develop" certain lands included the statement: "This will depend upon the possible profit status for the year 1957 in each of the companies." The tax returns of the various corporations formed by Mr. Fine as shown in the Exhibit B which the District Court included in its opinion shows that in 1950 the income from development and sale of homes reported by Adolph Fine, Inc. and Fine Realty, Inc. was $202,268.00 and $34,212.00. For the ensuing years 1951-1956 following the creation of the various development companies the taxable income of the two named companies dropped with but few exceptions to less than $25,000.00 and each of those companies reported less than $25,000.00. Notwithstanding Mr. Fine's testimony that avoidance of tax was not a prime consideration in splitting his home building business, there was substantial evidence to support the finding of the Court that the principal purpose was to avoid federal income or excess profit tax by securing the benefit of deductions and credits which he would not otherwise enjoy.

Appellant contends here as it did below that creation of a new corporation and obtaining its stock is not an acquisition of the control of a corporation within the meaning of [§269(a)]. The Court in rejecting the contention said [176 F. Supp. 310]:

> Although the legislative history and the case law under [§269] indicate that it was aimed at the abuses of one corporation acquiring going concerns which had accrued certain tax exemptions, see J. E. Dilworth Co. v. Henslee, D.C. Tenn. 1951, 98 F. Supp. 957, 960 (dictum); Rudick, Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code, 58 Harv. L. Rev. 196 (1944), there is no settled view that "acquisition of control" cannot and should not include the organization of a new corporation such as was done here. See Alcorn Wholesale Co., 1951, 16 T.C. 75, 88; 7 Mertens, Federal Taxation §38.66, n.75 (1956). The regulations promulgated under the 1939 Code provide that acquisition of control of a corporation may be accomplished by acquiring the stock of a newly organized corporation.

We find no error in the Trial Court's ruling on this contention.

Appellant also contends that [§269(a)] cannot be used to deny an acquired corporation its normal surtax deduction and excess profits credit but is limited in its application to denying an acquiring corporation which has acted to evade federal tax the "credit, deduction or allowance" it attempts to obtain through the acquired corporation. In ruling against this contention, the District Court said:

> Grammatically, this issue is presented in the interpretation of the words describing the method of tax avoidance. These are "by securing the benefit of a deduction, credit, or other allowance which such [acquiring] person or corporation would not otherwise enjoy." If the antecedent of "which" is "deduction, credit, or other allowance," then [§269] should be limited to disallowing deductions of the acquiring person. However, if the antecedent of "which" is "benefit," then the section can logically be applied to the deduc-

tions of the acquired corporation also, since the acquiring person will be benefiting from them. See Bernard, Acquisitions for Tax Benefit, 34 Cal. L. Rev. 36, 99-100 (1945).

A line of Tax Court cases had established the former interpretation by enunciating the basic principle that [§269] applies only to deductions of the acquiring person and not to those of the acquired corporation. . . . However recent courts of appeal cases reflecting, I think, the better reasoning, have held that deductions of the acquired corporation may also be properly disallowed. Mill Ridge Coal Co. v. Patterson, 5 Cir., 1959, 264 F.2d 713; Coastal Oil Storage Co. v. Commissioner, 4 Cir., 1957, 242 F.2d 396.

In the *Coastal Oil Storage* case, a parent corporation organized a subsidiary by transferring oil storage tanks to the subsidiary in exchange for its capital stock and a note. The business purpose motivating the transaction was allegedly to separate storage business under government contract from ordinary business. The Court found that the major purpose was tax avoidance and that [§269(a)] could be employed to disallow the acquired subsidiary its normal surtax exemption and its minimum excess profits credit. . . .

Whether the land transferred came from Fine himself, or from one of his corporations, the tax avoidance purpose seems clear. The potential income of Adolph Fine, Inc., and Fine Realty, Inc., were siphoned off to James Realty Co. and the evidence shows that the income from ownership of the developmental property was arbitrarily fragmentized into corporate units conveniently accruing just under $25,000 per year. Adolph Fine thus obtained the benefit of an extra set of surtax exemptions and excess profits credits that he would not otherwise have enjoyed and to which he was not entitled. . . .

[The court also referred to British Motor Car Distributors, Ltd. v. Commissioner, 278 F.2d 392 (9th Cir. 1960), similarly holding that §269 applies to the acquired corporation, and to Thomas S. Snyder Sons Co. v. Commissioner, 34 T.C. 400 (1960), in which the Tax Court abandoned its earlier approach to §269 and accepted the reasoning of the *British Motor Car* case.]

We are in accord with the interpretation of [§269(a)] in Mill Ridge Coal Co. v. Patterson, 5 Cir., 1959, 264 F.2d 713; Coastal Oil Storage v. Commissioner, 4 Cir., 1957, 242 F.2d 396; Commissioner v. British Motor Car Distributors, Ltd., 9 Cir., 1960, 278 F.2d 392, and Thomas S. Snyder Sons Co. v. Commissioner [supra], and hold that the Trial Court was not in error in applying [§269(a)] and upholding the disallowance made by the Commissioner of the deduction and credit claimed by the taxpayer.

In view of our conclusion in this case that the deduction claimed by the taxpayer was forbidden by [§269(a)] it is not necessary for us to pass upon the application and effect of [§1551] and we expressly refrain from doing so.

The judgment appealed from is affirmed.

NOTE

1. *Business purposes for multiple corporations.* In Aldon Homes, Inc. v. Commissioner, 33 T.C. 582, 597-600 (1959), the court commented as follows on the business purposes that, according to the taxpayers, were served by the use of multiple corporations in the development of a real estate subdivision:

Petitioners argue that the development of Tract 17169 through 16 corporations rather than through 1 served a number of business purposes: (1) That it enabled the avoidance of a possible general claim against the entire project in the event the development of any portion of the tract was a business failure; (2) that it limited possible tort liability; (3) that it eased the handling of mechanics' liens; and (4) that it facilitated the attraction of capital by reducing corporate taxes and thereby increasing the return to the parties. We are convinced, however, from our study of all the facts and circumstances that none of the alleged advantages in the use of multiple corporations in the development of Tract 17169 constituted any actual business purpose in the instant case. The alleged business purposes impressed us simply as a lawyer's marshaling of

possible business reasons that might conceivably have motivated the adoption of the forms here employed but which in fact played no part whatever in the utilization of the multiple corporate structure. Cf. Clearview Apartment Co., 25 T.C. 246, 253.

The enumerated purposes were little more than mere recitals by the witness Albert H. Allen, an attorney for Aldon Construction Company, who, with other tax counsel, recommended the multiple corporation plan and performed the legal work in connection with the organization of Aldon and the alphabet corporations, and who was also one of the investors in the project. There was little or no demonstration as to how they would operate to the economic benefit of Aldon or the alphabet corporations. Particularly is this true of the purpose to avoid the possibility of a "general claim" against the total project. We are left to surmise what the nature of such a claim might be with little to stimulate our imagination in this respect, except the reference to a suit resulting from an accident in the development of another tract. This, however, would appear to fall under the limitation of tort liability purpose. The benefits to be derived in this area from the use of multiple corporations are likewise unclear, particularly in view of the known custom of construction companies, as well as most businesses, to carry liability insurance, and the operation of workmen's compensation laws. The income tax returns filed by the alphabet corporations wherein deductions were claimed by each, in substantially the same amounts, for both "General" and "Workmen's Compensation" insurance, indicate they were fully protected in both respects. The stockholders already had the benefit of a "corporate shield" in Aldon, and on the evidence shown, the seeking of additional insulation through the formation of 16 more "corporate shields" was at best of minimal business significance. The first two enumerated purposes are further minimized by reason of the promises made (and later carried out) by the management group to share 50-50 with the investor group all profits derived from the development of the entire tract. Thus, the recovery of a "general" or "tort" claim against any portion would be spread over the entire tract.

We also see little merit in the contention that the use of multiple corporations was necessary to facilitate the handling of mechanics' liens. As a general rule mechanics' as well as materialmen's liens, are related in time of filing and in liability to the particular building or improvement for which they are furnished, though this may be and frequently is changed by the contract or arrangement under which they are supplied. See 36 Am. Jur., Mechanics' Liens, secs. 167-175. Here the houses were built on a mass production basis, that is, construction was initiated on lots in the first block of the subdivision and progressed lot by lot up and down the streets until the entire tract was completed. Workers moved from house to house as their phase of the work was ready to be done. Presumably materialmen's and mechanics' liens attached to the houses as completed and it is not made clear to us how the use of multiple corporations would "ease the handling of mechanics' liens" to any greater extent. As to the amounts of such liens, they too would be spread over the entire project if necessary to carry out the 50-50 division of profits. The recited purpose relating to the handling of mechanics' liens, as in the case of the first two enumerated purposes, was but a "make weight" factor secondary to the parties' primary objective of avoiding taxes.

Petitioners' argument that the use of the multiple corporate structure facilitated the attraction of capital by reducing corporate taxes and thereby increasing the return to the parties must also fail as a substantial business purpose. To hold otherwise would enable the clothing of any tax avoidance or tax evasion scheme with a business purpose, contrary to the statement of the Court of Appeals in National Investors Corp. v. Hoey, [144 F.2d 466, 468 (2d Cir. 1944)], that "escaping taxation is not a 'business' in the ordinary meaning." No difficulty whatever was experienced in obtaining sufficient capital to purchase the raw land and begin operations prior to the establishment of the 16 alphabet corporations. Some of the investor group testified they would have invested more if they had been permitted. The entire $300,000 was advanced to Aldon in the first instance and only later transferred to the alphabet corporations through a "round-robin" series of transactions. Not only were the advances by the investor group made to Aldon prior to the formation of the alphabet

corporations, but even after the latter were organized, as the evidence indicates, the individual investors were given no choice as to the particular alphabet corporation or corporations to which their interests would be transferred; they were merely furnished a mimeographed document showing the various assignments of interest which had been made by those in control of the project.

Also, the development of Tract 17169 was virtually guaranteed to be a business success before any part of it was transferred to the alphabet corporations. Metz and Woodrow, through Aldon Construction Company, had successfully developed a number of tracts and built thousands of houses prior to the development of Tract 17169. Their reputations as builders and the reputation of Aldon Construction were excellent. The president of one savings and loan institution testified, "There was competition for loans on houses which he [Metz] had built." In a letter dated July 20, 1951, Donna notified the Veterans' Administration that "the entire 237-house tract has been sold prior to the start of construction." Work had started on the project on or about December 18, 1950, several days before Aldon transferred the land to the various alphabet corporations. In an attempt to discount the above statement, petitioners argue that there could have been no "completed sale" prior to completion of the house. True, but there could have been "contracts to purchase" if and when completed, or escrow arrangements, which was the case here.

In Shaw Construction Co. v. Commissioner, 323 F.2d 316 (9th Cir. 1963), another subdivision case, the taxpayers asserted that they employed "multiples" because the lending institutions which supplied construction funds would not lend more than $100,000 to any one corporation and suggested dividing the property among a number of corporations, introducing in evidence a letter from one of the lending institutions to this effect. This argument collapsed when the lender's president testified that the idea of limiting the loans originated with the taxpayers or their attorney, who drafted the letter and requested that it be retyped on the lender's business stationery. Query: Does this kind of "window-dressing" constitute fraud?

Outside the real estate subdivision area, where the "balancing out" of income by the multiplication of corporate entities has been carried to a fine art, taxpayers have been somewhat more successful in establishing that two or more corporations were justified by the exigencies of business conditions. See Hiawatha Home Builders, Inc. v. Commissioner, 36 T.C. 491 (1961) (home construction business separated from cement subcontracting business, to protect latter from financial risks and to avoid direct competition with customers in construction industry); Cronstroms Manufacturing Co. v. Commissioner, 36 T.C. 500 (1961) (enterprise's two operating divisions and real estate transferred to separate corporations to reduce conflicts between divisional managers, facilitate profit-sharing plans, permit future sale of operating divisions, etc.); Pre-Mixed Concrete, Inc. v. Commissioner, ¶63,301 P-H Memo T.C. (delivery operations separated from manufacturing, in hope that organizational drive by Teamsters Union would ignore manufacturing employees); Sno-Frost, Inc. v. Commissioner, 31 T.C. 1058 (1959) (business divided under pressure from licensor of taxpayer's franchise).

2. *The government's weapons.* In addition to its "common law" weapons (Lucas v. Earl, *Clifford*, etc.) and its power to re-allocate gross income, deductions, etc. under §482, the government's arsenal includes two provisions that were specifically designed for corporations: §269 (the basis of the decision in *James Realty*) and §1551 (the alternative ground of the government's argument in *James Realty*, on which the court found it unnecessary to comment). In *Aldon Homes*, the government relied on §61(a) and §482 (citing §269 and §1551 only as alternatives); the court rested its decision solely on §61(a). Three judges concurred on the ground that a consolidation of income was authorized by §482, as interpreted by the *Advance Machinery Exchange* case (summarized supra p. 420n).

Section 1551, which was extensively revised in 1964, applies to certain transfers of property (other than money) to a corporation controlled by the transferor, if the transferee corporation was created to acquire the transferred property or was previously inactive. Unlike §269, which when applicable can result in a loss of any type of "deduction, credit, or other allowance," §1551 operates only to deny the surtax exemption and accumulated earnings credit. In another respect, however, §1551 is more sweeping than

§269, since the exemption and credit are denied whenever a transfer described by §1551 occurs, unless the transferee corporation "shall establish by the clear preponderance of the evidence that the securing of such exemption or credit was not a major purpose of such transfer." (Section 269 speaks of "principal purpose" and does not expressly place the burden of proof on the taxpayer.) In 1964, §1551 was enlarged to apply to certain transfers by individuals, whereas it had previously applied only to transfers by one corporation to another, and it was also amended to refer, explicitly, to "indirect" as well as "direct" transfers. For cases under the pre-1964 statute, see Truck Terminals, Inc. v. Commissioner, 33 T.C. 876 (1960) (tax-avoidance need not be sole or principal purpose; term "transfer" includes a sale of property by one corporation to another); Theatre Concessions, Inc. v. Commissioner, 29 T.C. 754 (1958) ("transfer" includes lease).

On reducing the corporate normal tax in 1964 from 30 per cent to 22 per cent (which increased the value of the surtax exemption), Congress acted to reduce the use of multiple corporations as a device for multiplying surtax exemptions, even in those instances where tax avoidance is not present (or cannot be proved). By virtue of §§1561-1563, certain related corporations are put to an election: they must either divide a single surtax exemption among themselves, or pay an additional tax of 6 per cent on the first $25,000 of taxable income. Since the additional tax does not eliminate the controlled group's extra surtax exemptions, but only reduces their potential value by $1,500 per exemption, it will ordinarily be the preferable alternative. Sections 1561-1563 apply to a "controlled group of corporations" (as defined), including "brother-sister" relationships as well as parent-subsidiary relationships. An election under §1562 to pay the additional 6 per cent tax for multiple surtax exemptions does not preclude a denial of the exemptions under §269 or §1551, but the additional 6 per cent tax will be taken into account in computing the deficiency resulting from disallowance of the exemption.

3. *Acquisition of "loss" corporations under the 1954 Code.* Section 269, discussed in the *James Realty Co.* case, was enacted in 1940 to combat the acquisition of corporations for the principal purpose of taking advantage of a tax history. The most spectacular transactions involved dormant corporations, with no tangible assets whatsoever, that had suffered a series of business losses that would have been depressing except for the operating loss carryforward that could be used — it was hoped — by transferring a profitable enterprise to the "loss" corporation or by merging it with a profitable corporation. Although §269 discouraged such transactions, it did not eliminate them entirely,* and in 1954 Congress attempted to sidestep the "principal purpose" requirement of §269 by

* "Loss" corporations are sometimes offered for sale in the Wall Street Journal and in the financial pages of other metropolitan newspapers. Their attractions have been noted even in the sport pages, as witness the following from the New York Times for November 3, 1953:

ORIOLES TO REBUILD CLUB WITH HELP OF INCOME TAX "CARRY BACK" ON $500,000

Baltimore Gains by Brown Losses

Tidy Sum Above Tax Saving to be Spent for Players

Oriole President Says

The Orioles disclosed today that their purchase of the Browns included a provision that makes the first half million dollars of net income tax free and every cent will go toward rebuilding the American League team.

And that isn't all.

"Over and above that half million we have a very tidy and substantial figure to spend this year for new players," said Clarence W. Miles, president of the new Orioles.

"I'm 56 years old," he continued. "I'd like to live long enough to win a pennant and a world series. I have only a few years left."

Miles told a luncheon of the Baltimore Sports Reporters Association that he was "letting his hair down" to them.

"We are blessed with one asset, the most important except for the franchise," he said. "That's a tax carry-back."

He explained that the Browns had lost half a million dollars "which we can take as a loss. It means that Baltimore won't have to pay taxes to that extent."

All to Be "Plowed Back"

He then promised that it all "will be plowed back into building up this ball club. No purchaser of a ball club ever enjoyed that before."

enacting two statutory provisions that operate in a more mechanical manner: §382(a), which reduces the net operating loss carryover if (roughly speaking) there is a major change in ownership of the loss corporation by virtue of purchases of stock within a specified period of time and the corporation abandons a business that was conducted before the change in ownership; and §382(b), which reduces the carryover if the loss corporation goes through a corporate reorganization and its shareholders acquire less than 20 per cent of the stock of the resulting corporation. See also Libson Shops, Inc. v. Koehler, 353 U.S. 382 (1957); Rev. Rul. 63-40, 1963-1 C.B. 46.

4. *Consolidated returns and the "loss" corporation.* An alternative mode of using a loss corporation's carryovers would be to acquire the corporation and cause it to file a consolidated income tax return with profitable corporations in the same affiliated group. Without waiting for legislation, however, the Treasury has used its power to prescribe regulations for the filing of consolidated returns (§1502) to permit pre-affiliation losses to be applied only against the post-affiliation profits of the loss corporation; similarly, the regulations permit a post-affiliation loss on the sale of depreciated property to be used only against the loss corporation's profits unless the loss is attributable to post-affiliation events. Regs. §1.1502-31(b)(3) and §1.1502-31(b)(9). In promulgating these restrictive rules, the Treasury had the support of some judicial decisions: Woolford Realty Co. v. Rose, 286 U.S. 319 (1932) ("The mind rebels against the notion that Congress in permitting a consolidated return was willing to foster an opportunity for juggling [by offsetting pre-affiliation losses against post-affiliation profits of other corporations] so facile and so obvious"); J. D. & A. B. Spreckels Co. v. Commissioner, 41 B.T.A. 370 (1940).

There remain some situations in which a loss corporation's carryovers can be utilized on a consolidated return. Does the management of a corporation that can bring a tax loss (or some other tax advantage) to a consolidated return have a fiduciary obligation to its minority shareholders or creditors to demand a quid pro quo before consenting to the filing of such a return? Mr. Justice Jackson had this to say (in a dissenting opinion) of an action brought by a subsidiary corporation's receiver against the parent corporation for unjust enrichment in "appropriating" the subsidiary's tax loss for use on a consolidated return, with a savings to the parent of $17,000,000 in taxes:

> Each of these corporations had something to contribute to a tax-saving plan. . . . It was as if a treasure of seventeen million dollars were offered by the Government to whomever might have two keys that would unlock it. Each of these parties had but one key, and how can it be said that the holder of the other key had nothing worth bargaining for? The management, probably without improper intent, failed to claim for the plaintiff the advantages of its position, turning them over without compensation for the advantage and profit of another affiliated corporation. On the face of it, the conclusion would seem to be warranted that the plaintiff is entitled to what fair arm's-length bargaining would probably have yielded. [Western Pacific R.R. Corp. v. Western Pacific R.R. Co., 345 U.S. 247, 276-277 (1953).]

The Court of Appeals had the last word, however, and the petition was dismissed:

> How could this court or the district court determine "what fair arm's-length bargaining would probably have yielded"? Bargaining presupposes negotiations to determine the maximum amount a buyer is willing to pay and the minimum amount a seller is willing to accept. Such activity is a matter of business administration, and is not a judicial function. [Western Pacific R.R. Corp. v. Western Pacific R.R. Co., 206 F.2d 495, 499-500 (9th Cir. 1953).]

See Case v. New York Central Railroad Co., 243 N.Y.S.2d 620 (1963) (agreement between parent and subsidiary for sharing the tax savings resulting from consolidated returns held unfair to minority shareholders of subsidiary).

5. *Other statutory restrictions on the use of multiple corporations.* Some of the recently enacted "incentive" provisions of the Code have contained dollar limitations that are applied to affiliated corporations as a group, rather than to each corporation as a separate entity. Thus, not more than $10,000 of investment may qualify in any one taxable year for the additional first-year depreciation allowance of §179, and this amount must be divided among the corporations that are members of an affiliated group (as defined).

Similarly, the $50,000 limit on the amount of used property that may qualify for the investment credit of §38 is applied to affiliated corporations as a group. So far as *individual* taxpayers are concerned, however, each person stands on his own feet; the fact that Smith has claimed the full allowance under §179 or §38 does not restrict the amount that may be claimed by his children, not even if he and they are members of a family partnership. (Special provisions are applicable to married taxpayers, because they may elect to file either joint or separate returns.)

6. *References.* Sharp, Multiple Tax Benefits Through Multiple Incorporation: Some Thoughts on the Law as It Is, and as It Ought to Be, 40 B.U.L. Rev. 375 (1960); Comment, Net Operating Loss Carryovers and Corporate Adjustments: Retaining an Advantageous Tax History Under Libson Shops and Sections 269, 381, and 382, 69 Yale L.J. 1201 (1960); Emmanuel, Section 15(c) [§1551]: New Teeth for the Reluctant Dragon? 8 Tax L. Rev. 457 (1953); Rice, Internal Revenue Code, Section 269: Does the Left Hand Know What the Right Is Doing? 103 U. of Pa. L. Rev. 579 (1955); Rudick, Acquisitions to Avoid Income or Excess Profits Tax: Section 129 [§269] of the Internal Revenue Code, 58 Harv. L. Rev. 196 (1944); Tarleau, Acquisition of Loss Companies, 31 Taxes 1050 (1953); Reese, Reorganization Transfers and Survival of Tax Attributes, 16 Tax L. Rev. 207 (1961); Germain, Carryovers in Corporate Acquisitions, 15 id. 35 (1959); Cohen, Phillips, Surrey, Tarleau, and Warren, The Internal Revenue Code of 1954: Carry-overs and the Accumulated Earnings Tax, 10 id. 277 (1955).

CHAPTER 5

Sales and Other Dispositions of Property

Despite some early judicial suggestions to the contrary, it has long been established that appreciation in the value of property may be taxed in toto in the year of sale, even though the appreciation accrued over a long period of time. The cases are reviewed in Merchants' Loan & Trust Co. v. Smietanka, supra page 69, which also held that the term "income" as used in the Sixteenth Amendment includes the gain on "a single isolated sale of property" as well as the profits from sales of property in the course of trade or business. Since Eisner v. Macomber, supra page 56, it has often been assumed that appreciation in the value of property cannot be taxed until it has been "realized" in some fashion. This assumption has not been subjected to a judicial test, however, because Congress has never required taxpayers to take unrealized appreciation into account in computing the year's taxable income.*

Whether a "realization" is required by the Constitution or not, however, it is implicit in §61(a)(3), which provides that gross income includes "gains derived from dealings in property." Presumably this provision is to be taken in conjunction with §1001, prescribing the method of determining the amount of gain or loss "from the sale or other disposition of property." But we have intimations, both from the courts and the Treasury, that the catch-all language of §61(a) — "gross income means all income from whatever source derived" — may reach peripheral items despite the lack of a "sale or other disposition." In Herbert's Estate v. Commissioner, 139 F.2d 756 (3d Cir. 1943), for example, it was held that a taxpayer who collected a debt from the obligor had engaged in a "sale or other disposition" of his claim, the issue arising because the taxpayer's basis for his claim was less than the amount collected. The court went on, however, to say that the taxpayer's gain could have been taxed under the more general language of §61(a), thus implying that §1001 was unnecessary to the result. This alternative theory is explicitly endorsed by Regs. §1.1001-1(c). In *Herbert's Estate*, it was irrelevant to the result whether the difference between the taxpayer's basis for the property and the amount collected was taxed under §1001 or under §61(a).

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* Security dealers may value their inventory of securities at market, and thus take unrealized appreciation and depreciation into account each year, under Regs. §1.471-5(c), but this method of computing income is optional rather than compulsory.

Although, as stated in the text, the courts have not been called upon to say whether Congress could *require* appreciation to be taken into account annually, the Court of Appeals for the Second Circuit stated in Shahmoon v. Commissioner, 185 F.2d 384 (2d Cir. 1950), that its discussion of a problem under §127 of the 1939 Code (relating to war losses) should not be understood as intimating "that we think taxation of appreciation would ever be unconstitutional."

The President's 1963 tax message to Congress (Jan. 24, 1963) recommended that the transfer of capital assets by gift or at death be treated as a taxable event. This proposal (which was not enacted) was a less drastic break with tradition than a tax based on an annual computation of the taxpayer's unrealized gain or loss on assets that have not in any way passed out of his possession, control, or enjoyment, since a transfer of property by gift or bequest is a disposition, even though the transferor receives nothing in return. The proposal might be regarded as presaged by several existing provisions requiring a corporation to report income on a distribution of certain types of appreciated property to its shareholders, e.g., §311(c) (relating to property subject to liability in excess of basis) and §1245(a)(1) (certain depreciable property).

But on other facts, the difference in theories may be crucial; consider the question whether a recovery in an unfair competition or private antitrust case is compensation for loss of profits or for destruction of goodwill. Note how the *Raytheon Production Corp.* case, supra page 86, would have been decided if the taxpayer had proved a basis for its goodwill.

Just as a transaction in property may produce income under §61(a) even though there is no "sale or other disposition," so §165(a) may permit the taxpayer to deduct a loss on property resulting from an event (such as theft or fire) that is not easily fitted into §1001's concept of a "sale or other disposition." Thus, abandonment of business property gives rise to a deductible loss, even though the taxpayer has not consigned the property to the junk heap or formally renounced title. See Helvering v. Gordon, infra page 582; Regs. §1.1001-1(c) (sale or other disposition "ordinarily," but presumably not always, required).

Although a "sale or other disposition" may not always be essential to the realization of gain or loss, the overwhelming mass of transactions in property fit easily within the language of §1001. It should be noted, however, that §1001 provides no more than a method for *computing* gain or loss; it does not tell us whether the gain or loss thus computed is to be recognized or otherwise taken into account in computing taxable income. Section 1001(c) explicitly refers us to §1002 for the "recognition" rules, and §1002 in turn provides that the entire amount of gain or loss is to be recognized unless one of the many "non-recognition" provisions is applicable. Some of these provisions are examined later in this chapter. When a loss is incurred on the sale or other disposition of property, however, it is especially important to recognize that neither §1001 nor §1002 authorizes the taxpayer to *deduct* the loss — §1001 and §1002 are wholly subordinate to such provisions as §165(c) (individual taxpayer may deduct only business, profit-oriented, and casualty losses), §267(a)(1) (no deduction for losses on sales of property between certain related taxpayers), §1091 (losses on "wash sales" nondeductible), and the like.

Finally, §61(a)(3), §1001, and §1002 are applicable with equal force whether the property involved is a "capital asset" or not. The special rules that determine whether the taxpayer's income or loss on the disposition of property will be treated as short-term or long-term capital gain or loss, rather than as ordinary income or loss, are considered in the next chapter. By way of anticipation, it may be noted that the capital gain and loss provisions ordinarily come into play only if the property in question is a "capital asset" and has been disposed of by the taxpayer in a transaction that constitutes a "sale or exchange." As will be seen, a transaction may be a "sale or other disposition" within the meaning of §1001(a) — so that gain or loss is realized — without qualifying as a "sale or exchange" for capital gain or loss purposes.

SECTION A. THE TAXABLE EVENT

Section 61(a)(3), providing that gross income includes "gains derived from dealings in property," carries forward, in abbreviated form, a similar provision of §22(a) of the 1939 Code.

Sections 1001 and 1002, providing for the computation and recognition of gain or loss, are virtually identical with §111 and §112(a) of the 1939 Code.

UNITED STATES v. DAVIS

370 U.S. 65 (1962)

MR. JUSTICE CLARK delivered the opinion of the Court.

These cases involve the tax consequences of a transfer of appreciated property

by Thomas Crawley Davis to his former wife pursuant to a property settlement agreement executed prior to divorce, as well as the deductibility of his payment of her legal expenses in connection therewith. The Court of Claims upset the Commissioner's determination that there was taxable gain on the transfer but upheld his ruling that the fees paid the wife's attorney were not deductible. We granted certiorari on a conflict in the Court of Appeals and the Court of Claims on the taxability of such transfers.[1] We have decided that the taxpayer did have a taxable gain on the transfer and that the wife's attorney's fees were not deductible.

In 1954 the taxpayer and his then wife made a voluntary property settlement and separation agreement calling for support payments to the wife and minor child in addition to the transfer of certain personal property to the wife. Under Delaware law all the property transferred was that of the taxpayer, subject to certain statutory marital rights of the wife including a right of intestate succession and a right upon divorce to a share of the husband's property. Specifically as a "division in settlement of their property" the taxpayer agreed to transfer to his wife, inter alia, 1,000 shares of stock in the E. I. duPont de Nemours & Co. The then Mrs. Davis agreed to accept this division "in full settlement and satisfaction of any and all claims and rights against the husband whatsoever (including but not by way of limitation, dower and all rights under the laws of testacy and intestacy). . . ." Pursuant to the above agreement which had been incorporated into the divorce decree, one-half of this stock was delivered in the tax year involved, 1955, and the balance thereafter. Davis' cost basis for the 1955 transfer was $74,775.37, and the fair market value of the 500 shares there transferred was $82,250. The taxpayer also agreed orally to pay the wife's legal expenses, and in 1955 he made payments to the wife's attorney, including $2,500 for services concerning tax matters relative to the property settlement.

I

The determination of the income tax consequences of the stock transfer described above is basically a two-step analysis: (1) Was the transaction a taxable event? (2) If so, how much taxable gain resulted therefrom? Originally the Tax Court (at that time the Board of Tax Appeals) held that the accretion to property transferred pursuant to a divorce settlement could not be taxed as capital gain to the transferor because the amount realized by the satisfaction of the husband's marital obligations was indeterminable and because, even if such benefit were ascertainable, the transaction was a nontaxable division of property. Mesta v. Commissioner, 42 B.T.A. 933 (1940); Halliwell v. Commissioner, 44 B.T.A. 740 (1941). However, upon being reversed in quick succession by the Courts of Appeals of the Third and Second Circuits, Commissioner v. Mesta, 123 F.2d 986 (C.A. 3d Cir. 1941); Commissioner v. Halliwell, 131 F.2d 642 (C.A. 2d Cir. 1942), the Tax Court accepted the position of these courts and has continued to apply these views in appropriate cases since that time. . . . In *Mesta* and *Halliwell* the Courts of Appeals reasoned that the accretion to the property was "realized" by the transfer and that this gain could be measured on the assumption that the relinquished marital rights were equal in value to the property transferred. The matter was considered settled until the Court of Appeals for the Sixth Circuit, in reversing the Tax Court, ruled that, although such a transfer might be a taxable event, the gain realized thereby could not be determined because of the impossibility of evaluating the fair market value of the

[1] The holding in the instant case is in accord with Commissioner v. Marshman, 279 F.2d 27 (C.A. 6th Cir. 1960), but is contra to the holdings in Commissioner v. Halliwell, 131 F.2d 642 (C.A. 2d Cir. 1942), and Commissioner v. Mesta, 123 F.2d 986 (C.A. 3d Cir. 1941).

wife's marital rights. Commissioner v. Marshman, 279 F.2d 27 (1960). In so holding that court specifically rejected the argument that these rights could be presumed to be equal in value to the property transferred for their release. This is essentially the position taken by the Court of Claims in the instant case.

II

We now turn to the threshold question of whether the transfer in issue was an appropriate occasion for taxing the accretion to the stock. There can be no doubt that Congress, as evidenced by its inclusive definition [in §61(a)] of income subject to taxation, i.e., "all income from whatever source derived, including . . . [g]ains derived from dealings in property," intended that the economic growth of this stock be taxed. The problem confronting us is simply when is such accretion to be taxed. Should the economic gain be presently assessed against taxpayer, or should this assessment await a subsequent transfer of the property by the wife? The controlling statutory language, which provides [§§1001 and 1002] that gains from dealings in property are to be taxed upon "sale or other disposition," is too general to include or exclude conclusively the transaction presently in issue. Recognizing this, the Government and the taxpayer argue by analogy with transactions more easily classified as within or without the ambient of taxable events. The taxpayer asserts that the present disposition is comparable to a nontaxable division of property between two co-owners,[2] while the Government contends it more resembles a taxable transfer of property in exchange for the release of an independent legal obligation. Neither disputes the validity of the other's starting point.

In support of his analogy the taxpayer argues that to draw a distinction between a wife's interest in the property of her husband in a common-law jurisdiction such as Delaware and the property interest of a wife in a typical community property jurisdiction would commit a double sin; for such differentiation would depend upon "elusive and subtle casuistries which . . . possess no relevance for tax purposes," Helvering v. Hallock, 309 U.S. 106, 118 (1940), and would create disparities between common-law and community property jurisdictions in contradiction to Congress' general policy of equality between the two. The taxpayer's analogy, however, stumbles on its own premise, for the inchoate rights granted a wife in her husband's property by the Delaware law do not even remotely reach the dignity of co-ownership. The wife has no interest — passive or active — over the management or disposition of her husband's personal property. Her rights are not descendable, and she must survive him to share in his intestate estate. Upon dissolution of the marriage she shares in the property only to such extent as the court deems "reasonable." 13 Del. Code Ann. §1531-(a). What is "reasonable" might be ascertained independently of the extent of

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[2] Any suggestion that the transaction in question was a gift is completely unrealistic. Property transferred pursuant to a negotiated settlement in return for the release of admittedly valuable rights is not a gift in any sense of the term. To intimate that there was a gift to the extent the value of the property exceeded that of the rights released not only invokes the erroneous premise that every exchange not precisely equal involves a gift but merely raises the measurement problem discussed in Part III [of this opinion]. Cases in which this Court has held transfers of property in exchange for the release of marital rights subject to gift taxes are based not on the premise that such transactions are inherently gifts but on the concept that in the contemplation of the gift tax statute they are to be taxed as gifts. Merrill v. Fahs, 324 U.S. 308 (1945); Commissioner v. Wemyss, 324 U.S. 303 (1945); see Harris v. Commissioner, 340 U.S. 106 (1950). In interpreting the particular income tax provisions here involved, we find ourselves unfettered by the language and considerations ingrained in the gift and estate tax statutes. See Farid-Es-Sultaneh v. Commissioner, 160 F.2d 812 (C.A. 2d Cir. 1947).

the husband's property by such criteria as the wife's financial condition, her needs in relation to her accustomed station in life, her age and health, the number of children and their ages, and the earning capacity of the husband. See, e.g., Beres v. Beres, 52 Del. 133, 154 A.2d 384 (1959).

This is not to say it would be completely illogical to consider the shearing off of the wife's rights in her husband's property as a division of that property, but we believe the contrary to be the more reasonable construction. Regardless of the tags, Delaware seems only to place a burden on the husband's property rather than to make the wife a part owner thereof. In the present context the rights of succession and reasonable share do not differ significantly from the husband's obligations of support and alimony. They all partake more of a personal liability of the husband than a property interest of the wife. The effectuation of these marital rights may ultimately result in the ownership of some of the husband's property as it did here, but certainly this happenstance does not equate the transaction with a division of property by co-owners. Although admittedly such a view may permit different tax treatment among the several States, this Court in the past has not ignored the differing effects on the federal taxing scheme of substantive differences between community property and common-law systems. E.g., Poe v. Seaborn, 282 U.S. 101 (1930). To be sure Congress has seen fit to alleviate this disparity in many areas, e.g., Revenue Act of 1948, 62 Stat. 110, but in other areas the facts of life are still with us.

Our interpretation of the general statutory language is fortified by the long-standing administrative practice as sounded and formalized by the settled state of law in the lower courts. The Commissioner's position was adopted in the early 40's by the Second and Third Circuits and by 1947 the Tax Court had acquiesced in this view. This settled rule was not disturbed by the Court of Appeals for the Sixth Circuit in 1960 or the Court of Claims in the instant case, for these latter courts in holding the gain indeterminable assumed that the transaction was otherwise a taxable event. Such unanimity of views in support of a position representing a reasonable construction of an ambiguous statute will not lightly be put aside. It is quite possible that this notorious construction was relied upon by numerous taxpayers as well as the Congress itself, which not only refrained from making any changes in the statutory language during more than a score of years but re-enacted this same language in 1954.

III

Having determined that the transaction was a taxable event, we now turn to the point on which the Court of Claims balked, viz., the measurement of the taxable gain realized by the taxpayer. The Code defines the taxable gain from the sale or disposition of property as being the "excess of the amount realized therefrom over the adjusted basis. . . ." I.R.C. (1954) §1001(a). The "amount realized" is further defined as "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. (1954) §1001(b). In the instant case the "property received" was the release of the wife's inchoate marital rights. The Court of Claims, following the Court of Appeals for the Sixth Circuit, found that there was no way to compute the fair market value of these marital rights and that it was thus impossible to determine the taxable gain realized by the taxpayer. We believe this conclusion was erroneous.

It must be assumed, we think, that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged. There was no evidence to the contrary here. Absent a readily ascertainable value it is accepted practice where property is exchanged

to hold, as did the Court of Claims in Philadelphia Park Amusement Co. v. United States, 130 Ct. Cl. 166, 172, 126 F. Supp. 184, 189 (1954), that the values "of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal." Accord, United States v. General Shoe Corp., 282 F.2d 9 (C.A. 6th Cir. 1960); International Freighting Corp. v. Commissioner, 135 F.2d 310 (C.A. 2d Cir. 1943). To be sure there is much to be said of the argument that such an assumption is weakened by the emotion, tension and practical necessities involved in divorce negotiations and the property settlements arising therefrom. However, once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences. Cf. Helvering v. Safe Deposit & Trust Co., 316 U.S. 56, 67 (1942).

Moreover, if the transaction is to be considered a taxable event as to the husband, the Court of Claims' position leaves up in the air the wife's basis for the property received. In the context of a taxable transfer by the husband,[3] all indicia point to a "cost" basis for this property in the hands of the wife [under §1012]. Yet under the Court of Claims' position her cost for this property, i.e., the value of the marital rights relinquished therefor, would be indeterminable, and on subsequent disposition of the property she might suffer inordinately over the Commissioner's assessment which she would have the burden of proving erroneous, Commissioner v. Hansen, 360 U.S. 446, 468 (1959). Our present holding that the value of these rights is ascertainable eliminates this problem; for the same calculation that determines the amount received by the husband fixes the amount given up by the wife, and this figure, i.e., the market value of the property transferred by the husband, will be taken by her as her tax basis for the property received.

Finally, it must be noted that here, as well as in relation to the question of whether the event is taxable, we draw support from the prior administrative practice and judicial approval of that practice. See supra. We therefore conclude that the Commissioner's assessment of a taxable gain based upon the value of the stock at the date of its transfer has not been shown erroneous.

IV

[Discussion of attorney fee question omitted.]

Reversed in part and affirmed in part.

MR. JUSTICE FRANKFURTER took no part in the decision of these cases.

MR. JUSTICE WHITE took no part in the consideration or decision of these cases.

NOTE

1. *The scope of the Davis case.* The following is from the cross-examination of Mr. Davis at the trial (Record, p. 54):

Q. Did you consider the delivery of the stock to be a gift to Mrs. Davis?
A. No. I considered it an exaction from me.
Q. And what do you mean by "an exaction"?

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3 Under the present administrative practice, the release of marital rights in exchange for property or other consideration is not considered a taxable event as to the wife. For a discussion of the difficulties confronting a wife under a contrary approach, see Taylor and Schwartz, Tax Aspects of Marital Property Agreements, 7 Tax L. Rev. 19, 30 (1951); Comment, The Lump Sum Divorce Settlement as a Taxable Exchange, 8 U.C.L.A.L. Rev. 593, 601-602 (1961).

A. What do you mean by a "gift"? . . .
Q. Let me put it like this: isn't it true, Mr. Davis, that in return for her separation you agreed to do certain things, one of which was the transfer of the stock?
A. No.
Q. How would you —
A. I have answered your question.
Q. I don't think you have, sir.
A. What I did was under duress, under pressure. The only way to continue to live.

In rejecting as "completely unrealistic" the suggestion that the transfer by Mr. Davis was a gift (footnote 2), was the Court relying on the facts of this case, or does it hold that a transfer in settlement of a wife's marital rights is a taxable event no matter how amicable the parting may be? Was it crucial that the settlement was in contemplation of divorce, or that it was incorporated in a divorce decree? Consider whether the husband in the *Farid-es-Sultaneh* case (supra page 133) realized gain by reason of his foresighted pre-marital transfer of property to his fiancee. If depreciated securities had been transferred in the *Davis* case, would the taxpayer have been entitled to deduct his loss, in the light of United States v. Gilmore (supra page 236)? What about §267(a)(1), disallowing the loss incurred on a sale of property to the taxpayer's "spouse"? In Pullian v. Commissioner, 39 T.C. 883 (1963), applying the *Davis* case, the court apparently allowed the taxpayer's gain on the transfer of property to his wife in a divorce settlement to be computed on a consolidated basis, so that depreciation in the value of one item of property was set off against the appreciation on others; but depreciation in the value of his personal residence was disregarded on the ground that "loss from the disposition of one's residence is personal and not deductible."

If the settlement in the *Davis* case had taken the form of a trust under which the wife was given the right to the income for life, with remainder to their children, would the transfer have been a taxable event? Consider the applicability of Regs. §1.1001(c)(1):

> Even though property is not sold or otherwise disposed of, gain is realized if the sum of all the amounts received which are required by section 1016 and other applicable provisions of subtitle A of the Code to be applied against the basis of the property exceeds the basis.

If the taxpayer realizes gain on transferring a life estate in appreciated property to the wife, what about a trust under which she has more limited rights (e.g., the 1933 trust in the *Mahana* case, supra page 178, the income from which was to go to the wife only if the income from the 1923 trust fell short of $17,500 per year)?

Is the *Davis* principle confined to divorce settlements, or does it also embrace transfers in connection with legal and informal separation agreements? Transfers to children, parents, or others in discharge of the taxpayer's duty of support?

Mr. Davis testified at the trial of the tax case that in 1953 (the year before the property settlement) his wife repeatedly requested him to transfer part of his duPont stock to her, that "because of this, our continual friction and bickering, in September of 1953, I made a donation to Mrs. Davis, a gift to Mrs. Davis of 200 shares of duPont stock" (Record, p. 41), and that this event preceded any discussion of divorce or separation. Did he realize gain on this transfer? He also testified that in 1954 his wife said that she would sign no more joint income tax returns "until you have met my demands." Would a transfer of appreciated property under these circumstances have been a taxable event?

For the gift tax problems arising out of marital settlements, see pages 1025-1048 infra.

See generally Kilbourn, Puzzling Problems in Property Settlements — The Tax Anatomy of Divorce, 27 Mo. L. Rev. 354 (1962) (written after the Court of Claims decided the *Davis* case, but before the Supreme Court decision).

2. *The transferee in the Davis case.* Did Mrs. Davis realize a taxable gain on her receipt of the stock? The Court indicates that Mrs. Davis gave up some rights in exchange for the stock: was this a "sale or other disposition of property" by her? Even if it was not a transaction within the ambit of §1001, did she realize gain under §61(a)? What if she received more than the estimated value of her right to be supported by her husband?

3. *Non-taxable divisions of property.* As to the taxpayer's contention in *Davis* that the

transfer should have been viewed as a "non-taxable division of property between two co-owners," see Rev. Rul. 56-437, 1956-2 C.B. 507:

> The conversion, for the purpose of eliminating a survivorship feature, of a joint tenancy in capital stock of a corporation into a tenancy in common is a nontaxable transaction for Federal income tax purposes. Likewise, the severance of a joint tenancy in stock of a corporation, under a partition action instituted under [a Colorado statute, similar to those in force elsewhere], compelling partition and the issuance of two separate stock certificates in the names of each of the joint tenants, is a nontaxable transaction. In each case there was no sale or exchange and the taxpayers neither realized a taxable gain nor sustained a deductible loss.

If the record ownership of a married couple's securities, residence, or other property is in their joint names, with right of survivorship, will a division of the property upon divorce be a non-taxable event under Rev. Rul. 56-437, or can the government go behind the record ownership to ascertain whether joint ownership was "really" intended? Conversely, does the *Davis* case preclude a showing that investments acquired during marriage were intended to be jointly owned, notwithstanding a failure to record title in both names?

The Court in the *Davis* case accepts the previously applied principle that a division of community property upon the dissolution of a marriage is not a taxable event. If one spouse takes substantially all the community property and compensates the other spouse in cash, however, the transaction will be treated as a sale by the latter spouse of his or her one-half interest in the community property. See Edwards v. Commissioner, 22 T.C. 65 (1954), and cases there cited.

4. *Payment of debt with appreciated or depreciated property.* The use of appreciated or depreciated property to pay a debt is a taxable event, because of its similarity to a sale of the property followed by a payment of the proceeds to the creditor. Simms v. Commissioner, 28 B.T.A. 988, 1029 (1933) (third issue). In International Freighting Corp. v. Commissioner, cited in the *Davis* case, an employer was taxed on the difference between the adjusted basis and the fair market value of stock transferred to employees under a bonus plan, presumably on the theory that the employer had received the benefit of the property's fair market value although there was no pre-existing debt. See also United States v. General Shoe Corp., 282 F.2d 9 (6th Cir. 1960). Would the result be the same if the taxpayer was not entitled to deduct the payment (for example, because the property was used to pay a bribe)?

As to transfers of appreciated or depreciated property to a charity in discharge of a pledge, see Rev. Rul. 55-410, supra page 176. If the reasoning of the ruling does not seem entirely persuasive, note that taxpayers have long been permitted to deduct the fair market value of appreciated property donated to charities (up to the amount of §170's percentage limitation) without recognizing any gain; and consider whether the result should be different if the taxpayer impulsively fills out a pledge card with a specific dollar amount rather than following the more prudent course of promising merely to give specified property in kind. For an attempt to limit the no-taxable-event doctrine where the charity is under an express or implicit obligation to dispose of the property, see Rev. Rul. 60-370, 1960-2 C.B. 203 (sale imputed to donor, in "Pomona Plan" transaction); see Trautman, Taxation of Gifts in Trust to Charities Reserving a Life Income Interest, 14 Vanderbilt L. Rev. 597 (1961).

5. *Cash bequests satisfied with property.* When a decedent's estate transfers property to an heir in satisfaction of a bequest of specific property, the transfer is not a taxable event, even though the property may have appreciated in value while held by the estate. Since a legacy of a specific monetary sum creates a debt running from the decedent's estate to the legatee, however, it has been held that a transfer of appreciated property in satisfaction of such a legacy is a "sale or other disposition" on which the estate realizes income. Suisman v. Eaton, 15 F. Supp. 113 (D. Conn. 1935), aff'd per curiam, 83 F.2d 1019 (2d Cir. 1936). As to a legacy calling for the payment of a stated sum in either money or property, see Kenan v. Commissioner, 114 F.2d 217, 219 (2d Cir. 1940):

> In the present case, the legatee had a claim which was a charge against the trust estate for $5,000,000 in cash or securities and the trustees had the power to determine

> whether the claim should be satisfied in one form or the other. The claim, though enforceable only in the alternative, was, like the claim in Suisman v. Eaton . . . a charge against the entire trust estate. If it were satisfied by a cash payment securities might have to be sold on which (if those actually delivered in specie were selected) a taxable gain would necessarily have been realized. Instead of making such a sale the trustees delivered the securities and exchanged them pro tanto for the general claim of the legatee, which was thereby satisfied.

See also Spedden v. Commissioner, ¶39,038 P-H Memo T.C., where the executor was directed by the decedent's will to sell all of his property, to pay several monetary legacies, and to pay the residue to his widow. The executor sold enough property to pay the legacies, and transferred the balance of the property (which had appreciated in value after the decedent's death) to the widow in a "sale" in which no money changed hands because the "proceeds" realized by the estate were credited to her as residuary legatee. The transfer to the widow was held to be a taxable event. How could the will have been drafted to avoid this result?

For an application of these principles to testamentary transfers under marital deduction clauses, see Regs. §1.1014-4(a)(3); infra page 1314.

See generally Roberts and Muller, Constructive Receipt of Income by Estates and Trusts Through Distribution in Kind to Beneficiaries, 4 Tax L. Rev. 372 (1949).

6. *Date of "sale or other disposition."* Ordinarily it is not difficult to determine the taxable year in which the sale or other disposition of property occurred, but uncertainty may be introduced by an escrow arrangement, a provision for deferred payments with a retention of control in the vendor, etc. Because much of the litigation in this area has arisen under the "holding period" requirement of the capital gain and loss provisions, the problems are examined infra page 585. A dispute over the year of disposition is also not uncommon when the taxpayer claims a loss on the ground that he disposed of property by abandoning it. For this problem, see Hillcone Steamship Co. v. Commissioner, ¶63,220 P-H Memo T.C.

WOODSAM ASSOCIATES, INC. v. COMMISSIONER

198 F.2d 357 (2d Cir. 1952)

Before SWAN, Chief Judge, and CHASE and CLARK, Circuit Judges.

CHASE, Circuit Judge. . . .

[The taxpayer's adjusted basis for certain real estate depended upon its basis in the hands of a shareholder, Mrs. Wood, from whom the property had been received in a non-taxable exchange in 1934.

[Much simplified, the relevant facts were: Mrs. Wood purchased the property in 1922 for about $300,000. In 1931, when her adjusted basis had been reduced to about $270,000 by reason of depreciation deductions, she obtained a mortgage in the amount of $400,000 on the property, using a "dummy" so that she incurred no personal liability on the mortgage. Disregarding this transaction, the government asserted that the taxpayer's adjusted basis for the property was its original cost to Mrs. Wood, plus the cost of certain improvements, and less the depreciation deducted by her between 1922 and 1934 and by the taxpayer thereafter.]

The contention of the petitioner may now be stated quite simply. It is that, when the borrowings of Mrs. Wood subsequent to her acquisition of the property became charges solely upon the property itself [in 1931], the cash she received for the repayment of which she was not personally liable was a gain then taxable to her as income to the extent that the mortgage indebtedness [$400,000] exceeded her adjusted basis in the property [$270,000]. That being so, it is argued that her tax basis was, under familiar principles of tax law, increased by the amount of such taxable gain [$130,000] and that this stepped up basis carried over to the petitioner in the tax free exchange by which it acquired the property.

While this conclusion would be sound if the premise on which it is based were

correct, we cannot accept the premise. It is that the petitioner's transferor made a taxable disposition of the property, within the meaning of [§1001(a)], when the [$400,000] mortgage was executed, because she had, by then, dealt with it in such a way that she had received cash, in excess of her basis, which, at that time, she was freed from any personal obligation to repay. Nevertheless, whether or not [the mortgagor is] personally liable on the mortgage, "The mortgagee is a creditor, and in effect nothing more than a preferred creditor, even though the mortgagor is not liable for the debt. He is not the less a creditor because he has recourse only to the land, unless we are to deny the term to one who may levy upon only a part of his debtor's assets." C.I.R. v. Crane, 2 Cir., 153 F.2d 504, 506. Mrs. Wood merely augmented the existing mortgage indebtedness when she borrowed each time and, far from closing the venture, remained in a position to borrow more if and when circumstances permitted and she so desired. And so, she never "disposed" of the property to create a taxable event which [§1001(a)] makes a condition precedent to the taxation of gain. "Disposition," within the meaning of [§1001(a)], is the " 'getting rid, or making over, of anything; relinquishment.' " Herbert's Estate v. Commissioner, 3 Cir., 139 F.2d 756, 758, certiorari denied 322 U.S. 752. Nothing of that nature was done here by the mere execution of the [1931] mortgage; Mrs. Wood was the owner of this property in the same sense after the execution of this mortgage that she was before. As was pointed out in our decision in the *Crane* case, supra, 153 F.2d 505-506, ". . . the lien of a mortgage does not make the mortgagee a cotenant; the mortgagor is the owner for all purposes; indeed that is why the 'gage' is 'mort,' as distinguished from a 'vivum vadium.' Kortright v. Cady, 21 N.Y. 343, 344. He has all the income from the property; he manages it; he may sell it; any increase in its value goes to him; any decrease falls on him, until the value goes below the amount of the lien." Realization of gain was, therefore, postponed for taxation until there was a final disposition of the property at the time of the foreclosure sale. See Lutz & Schramm Co., 1 T.C. 682; Mendham Corp., 9 T.C. 320. Therefore, Mrs. Wood's borrowings did not change the basis for the computation of gain or loss.

Affirmed.

NOTE

1. *Gain on excessively mortgaged property.* If Mrs. Woods had retained the property, instead of transferring it to a controlled corporation, her gain on ultimately disposing of it would have reflected the unrecognized increment which she received in 1931. To illustrate, assume that the depreciation deductions taken after 1931 amounted to $50,000, so that her adjusted basis at the time of sale was $220,000, and that the sale price was $450,000 (i.e., $50,000 above the mortgage). Her gain would have been $230,000, which would have corresponded to her cash receipts of $450,000 ($400,000 in 1931 plus $50,000 on the sale), less her original cash outlay ($300,000) plus her depreciation deductions ($80,000). In the *Woodsam Associates* case itself, the same principle was employed in computing the gain, but it was taxed to the corporation, rather than to Mrs. Woods. (In fact, the property was transferred by the corporation to the mortgagee for the unpaid principal of the mortgage, so that the gain was restricted to the excess of the mortgage over the corporation's basis, an aspect of the case that is considered infra pages 463-466.) But what if the property had been abandoned to the municipality for non-payment of local taxes, or transferred by gift to a charity? If Mrs. Woods had held the property until her death, would its basis to her heirs be its fair market value at death under §1014, so that the "excess" cash received by her in 1931 would never be taken into account?

If the court had held in the *Woodsam* case that gain is realized on mortgaging property for more than its adjusted basis when the taxpayer is not personally liable on the debt, would it be necessary to treat cases in which the mortgagor is ostensibly personally liable in the same fashion if the personal liability exceeded his present or probable future net

worth? In the case of a corporation that owns only a single parcel of property (e.g., an apartment house), is it realistic to distinguish between a mortgage with personal liability and one without?

2. *Step transactions.* In Simon v. Commissioner, 285 F.2d 422 (3d Cir. 1960), the taxpayer mortgaged property for more than its adjusted basis, using a "dummy" to avoid personal liability, and immediately thereafter transferred the property (subject to the mortgage) to a corporation of which he owned half the stock, the purpose of the transaction being to improve the financial position of a wholly owned subsidiary of the transferee corporation. The court held that the excess of the mortgage proceeds over the adjusted basis of the property was taxable gain to the taxpayer, on the ground that the transaction was in substance the same as a sale of the property to the transferee corporation for the amount of the mortgage proceeds, with the transferee obtaining the necessary funds by mortgaging the property. Note that there was a long interval in *Woodsam Associates* between the mortgage and the transfer of the property, whereas in *Simon* the court held that the mortgage and the transfer constituted "a single integrated transaction." See also Magnolia Development Corp. v. Commissioner, ¶60,177 P-H Memo T.C. (taxpayer satisfied pledge of $500 to charity by transferring stock worth $42,500 but subject to loan of $42,000, the loan having been obtained in anticipation of a sale by the charity to a person with whom the taxpayer had negotiated; held, transaction was in substance a sale by taxpayer for $42,500, followed by a charitable gift of $500).

3. *Statutory provisions taxing gain on excessively mortgaged property.* Section 357(c), enacted in 1954 and not applicable to the taxable years involved in either *Woodsam Associates* or *Simon*, provides for the recognition of gain on certain transfers of property (primarily in transfers to controlled corporations and in corporate reorganizations) if the property is subject to a liability in excess of its basis. A similar provision, applicable if a corporation transfers excessively mortgaged property to its shareholders, is §311(c); see also §312(j). These provisions may come into play even though the mortgage did not originally exceed the adjusted basis of the property; it is enough that there is a disparity (possibly resulting from depreciation deductions) when the property is transferred.

4. *Federal crop loans.* Federal loans to farmers under the agricultural price support program are made on the sole security of the commodities, without personal liability, and §77 permits the farmer, at his election, to report such a loan as income when received. The election protects the farmer against having "useless" deductions in the year the crop is raised, and an excessive amount of income in the year it is sold or forfeited to the government. If the taxpayer does not make an election under §77, he may be able to use any excessive business deductions arising in the year the crop is raised as part of an operating loss carryover to other years, but the election affords greater assurance that his expenses will be brought into conjunction with his receipts. An alternative way of accomplishing a similar result is the crop inventory method of reporting income. See Thompson v. Commissioner, 322 F.2d 122 (5th Cir. 1963).

5. *References.* Spears, Mortgages in Excess of Basis, 1959 So. Calif. Tax Inst. 883; Lurie, Mortgagor's Gain on Mortgaging Property for More Than Cost Without Personal Liability, 6 Tax L. Rev. 319 (1951) (by counsel for the taxpayer in the *Woodsam Associates* case); Neuhoff, Mortgaging Out and Related Problems, 1961 Wash. U.L.Q. 1.

STARR'S ESTATE v. COMMISSIONER

[See opinion in this case supra page 249.]

NOTE

1. *Sale vs. lease.* Should the manufacturer in *Starr's Estate* treat the transaction as a sale? If so, should the amounts to be received be accrued as income in the year the "lease" is executed, or only as the annual payments are received? In Rev. Rul. 55-540, 1955-2 C.B. 39, the Internal Revenue Service states that if a "lease" is determined to be a sale, "the amounts received under the contract by the vendor will be considered to be payments on the sales price of the equipment to the extent such amounts do not represent interest or other charges." If — contrary to expectation — the "lessee" does not take up his

option to acquire the property, how should the "lessor" reflect this fact on his tax returns?

See Lukins, Tax Treatment of the Lease with Option to Purchase: Is Allocation the Answer, 11 Tax L. Rev. 65 (1955).

The effect of sale-and-leaseback transactions is considered infra pages 466-470.

2. *Sale vs. loan.* Just as a lease in form may be a sale in substance, so a sale with the "vendor" retaining the right to repurchase the property may be treated as a secured loan and hence not a taxable event. In Blake v. Commissioner, 8 T.C. 546 (1947), the taxpayer avoided foreclosure of a mortgage by conveying the mortgaged property to the mortgagee and retaining an option to reacquire the property for an amount approximating the unpaid portion of the purchase price. Finding that the transaction was intended to give the taxpayer more time to satisfy the mortgage and to obviate the cost and delay of foreclosure proceedings in case of final default, the court held that the transaction was a loan rather than a sale. But in Resthaven Memorial Cemetery, Inc. v. Commissioner, 43 B.T.A. 683 (1941), a repurchase option that could be defeated by the occurrence of an event within the control of someone other than the option holder was held to be consistent with a completed sale.

3. *Easements.* If the taxpayer is paid for an easement over his real estate, is the payment taxable (a) to the extent that it exceeds the adjusted basis of the entire property, (b) to the extent it exceeds the adjusted basis of that part of the property that is most directly affected by the easement, or (c) in full, without being offset by any part of the property's basis? See Scales v. Commissioner, 10 B.T.A. 1024 (1928) (perpetual easement to flood part of taxpayer's land was granted to a levee improvement district; held, a sale of the portion of the land that was flooded by the district for 10 out of 12 months every year); Rev. Rul. 59-121, 1959-1 C.B. 212 (easement of indefinite duration granted by owner of cattle-grazing land to industrial plant for construction of a dam on part of property and for use of portions of land to dump waste; held, taxpayer's retention of mineral rights, etc., means that transaction is not a sale of part of the land, with result that amount received is to be applied against basis of property subject to easement, any excess over basis being taxable income); Rev. Rul. 60-170, 1960-1 C.B. 357 (payments received by farmers from neighboring steel plant for damage from fumes, gases, etc. held to be "rent," for purposes of self-employment tax).

See also the *Inaja Land Co.* case, supra page 68.

4. *Amounts received for options.* If the taxpayer receives payment for an option under which the optionee can purchase the taxpayer's property (e.g., a "call" on corporate securities) at a stipulated price for a limited period of time, Rev. Rul. 58-234, 1958-1 C.B. 279, provides that the transaction is not closed until the option is either exercised (in which event the "amount realized" in computing the taxpayer's gain or loss is the sum of the amount received for the option and the amount received on its exercise) or is allowed to expire (in which event the amount received for the option is reported as income at that time). Similarly, if the taxpayer is paid for agreeing to buy the optionee's property at a stipulated price within a specified period of time (a so-called "put"), he realizes income if the option expires without exercise; if it is exercised, his "cost" for the property is the amount he pays less the amount he previously received on granting the option. Although Rev. Rul. 58-234 is primarily concerned with "puts" and "calls" on marketable securities, it apparently applies to options covering any type of property; nor does the ruling appear to be restricted to options for the short terms (e.g., 30 days up to one year) that are typical in the "put" and "call" market. See also Commissioner v. Dill Co., 294 F.2d 291 (3d Cir. 1961).

See Bennion, Current Developments in Tax Planning with Securities Transactions: "Puts"; "Calls"; "Straddles"; "Short Sales"; "Arbitrage," 1961 So. Calif. Tax Inst. 489.

COMMISSIONER v. OLMSTED INC. LIFE AGENCY

304 F.2d 16 (8th Cir. 1962)

Before VOGEL and RIDGE, Circuit Judges, and DEVITT, District Judge.

VOGEL, Circuit Judge.

The Commissioner of Internal Revenue, petitioner herein, seeks review and

reversal of a decision by the Tax Court of the United States holding that Olmsted Incorporated Life Agency, respondent, did not realize taxable income upon the receipt by it in 1956 of a contract whereby it was to be paid monthly payments for a period of fifteen years in consideration for its surrender of all rights to future renewal commissions on previously written life insurance policies.

The facts, mainly stipulated, are not in dispute. Respondent is an Iowa corporation having its principal place of business in Des Moines, its main activity, beginning June 15, 1929, being that of exclusive general insurance agent in the State of Iowa for the Peoples Life Insurance Company of Frankfort, Indiana (hereinafter Peoples). The original agency contract between respondent and Peoples was signed on respondent's behalf by Oliver C. Miller, its president and principal stockholder who died in 1957. Two or three years prior to 1956, Peoples, because of its desire to develop insurance sales in Iowa by dividing the state into smaller territories, indicated its wish to terminate its exclusive contract with respondent. Under that contract Peoples was paying more favorable commissions to respondent than it was paying to other agencies under contracts executed subsequent to 1950. Miller did not at first accept Peoples' proposal, but subsequently, because of failing health, he did enter into a new agreement whereby the old agency agreement between respondent and Peoples was canceled as of midnight December 31, 1955. Under the terms of the new agreement, respondent assigned to Peoples all of its rights in and to renewal commissions earned and payable after January 1, 1956. Respondent and its three stockholders agreed not to sell life insurance contracts for any other than Peoples within the State of Iowa. Respondent agreed to turn over to Peoples all papers, documents and records pertaining to its business, and Peoples agreed to issue, payable to the order of respondent or to such person or persons as respondent might direct, an annuity or annuities calling for a total payment of $500 per month beginning February 1, 1956, for a total of 180 months. Peoples based the total amount of consideration it would pay to respondent under the new agreement upon the present value of respondent's renewal commissions that would be due after January 1, 1956. As a further consideration, Peoples agreed to pay the agents theretofore employed by the respondent such renewal commissions as might be required by their contracts with respondent.

In its 1956 corporate income tax return respondent reported $5,500, being the total of payments actually received that year pursuant to the new contract. The Commissioner determined a deficiency in the respondent's return for 1956 in the amount of $27,009.34, taking the position that the entire fair market value ($67,924.47) of the new contract, whereby respondent gave up its rights to future renewal commissions and received in place thereof a fixed income over a period of fifteen years, should have been included in respondent's gross income for the year 1956. The Tax Court, in 35 T.C. 429, rejected the Commissioner's contention, holding that the case was ruled by James F. Oates, 18 T.C. 570, affirmed in Commissioner v. Oates, 7 Cir., 1953, 207 F.2d 711. . . .

The Commissioner relies on Bueltermann v. United States, 8 Cir., 1946, 155 F.2d 597, and Herbert's Estate v. Commissioner, 3 Cir., 1943, 139 F.2d 756, certiorari denied 322 U.S. 752, as support for his contention that there was a "sale or other disposition" within the meaning of Section 1001, supra. However, it should be noted that in both of the cases cited there was a transfer of property involved. In *Bueltermann*, a lease required the lessee to erect a building. The lessor died and devised the rights and land to the taxpayer. The lessee breached the contract, and the taxpayer, in accordance with provisions therein, took over the land including the building that the lessee had erected thereon. It was stated there that the phrase "sale or other disposition of property" was sufficiently

broad to include such transaction within the meaning of [§1001(a)].* However, the factual situation there involved has no applicability here.

In *Herbert's Estate,* where the decedent had a claim for $531,817.75, though the fair market value of said claim at the time of decedent's demise was $200,191.-90, and where recovery on the claim to the extent of $295,803.61 was made, it was held there was a gain of some $95,000. In that case, the court said the issue was whether there was "a disposition" under Section 1001 where one receives payment for a claim he has against another. The court answered in the affirmative. However, there the money was received. That is not the situation before us. Payment here (other than the $5,500 received in 1956 and included in respondent's report) is absent. All that has occurred is the exchange of one contract for another, the principal change therein being the rate of payment. . . .

Inasmuch as the Tax Court held this case to be controlled by *Oates,* supra, and the Commissioner seeks to distinguish that case,[1] detailed consideration is indicated to determine its applicability.

In *Oates,* the taxpayers were general insurance agents who, at retirement, amended their agency agreement with the insurance company by providing that future renewal commissions should be paid to them in specified equal monthly amounts over a fifteen-year period irrespective of when and in what amounts the renewal commissions would have become due and payable under the original agency contract. The obvious reason was that under the taxpayers' old contracts, the bulk of their renewal commissions would be collected by them in the first years after retirement and toward the end of the ninth year collections would dwindle off to little or nothing. Thereafter, and in accordance with the election given by the amended contract, the taxpayers elected to receive their payments in equal amounts over a fifteen-year period with a provision for a lump sum final payment if anything remained in the agents' renewal commission account. The Commissioner determined that the taxpayers there were taxable on the renewal commissions as they accrued under the terms of the original agency contract prior to its amendment. In rejecting the Commissioner's contention, the Tax Court in 18 T.C. 570 said that the taxpayers

> . . . under their amended contracts which were signed prior to their retirement . . . were not entitled to receive any more than they did in fact receive and that being on the cash basis they can only be taxed on these amounts [actually received] and that the remainder will be taxed to them if and when received by them. [18 T.C. at 585.]

By unanimous decision, the Seventh Circuit affirmed the Tax Court. In doing so, that court said that the amended contract was a novation, that the old contract was extinguished, and that the taxpayer had no right to demand any additional compensation other than that which was listed in the new contract. Then after discussing Massachusetts Mutual Life Ins. Co. v. United States, 1933, 288 U.S. 269, as support for its affirmance of the Tax Court, Judge Lindley, referring to cases relied upon by the Commissioner wherein each taxpayer had "effectually

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* In the *Bueltermann* case, the government argued that the value of the building erected by the lessee was taxable income to the lessor under the *Bruun* case when the lease was terminated because of the lessee's default in performance. The taxpayer's claim — upheld by the court — was that the transaction constituted a "sale or other disposition" of his inherited interest in the property, that this interest had a basis equal to its value on the date of his father's death, and that he realized no gain because the value of the property received was less than the adjusted basis of the property he gave up. — ED.

1 We are advised that on February 1, 1960, the Commissioner withdrew his 1952 non-acquiescence in this decision and substituted his acquiescence therefor. [Rev. Rul. 60-31, 1960-1 C.B. 174, 180.]

received the accrued income with which he was charged," said at pages 713-714 of 207 F.2d:

> This case is far removed from such decisions. Here the parties were confronted by a situation where inconvenience and resulting dissatisfaction came to the retired agents by reason of the constantly decreasing payments made by the company under the original contract. To relieve the situation, the company and the taxpayer, after full and complete negotiations, before retirement of the agent, agreed to abrogate and annul the old contract, to substitute a new one and thus to improve the unsatisfactory posture of affairs. *The taxpayer did not reduce to his immediate possession or to his present enjoyment anything that might thereafter accrue to him. He made no assignment; he took no dominion over the accrued commissions other than to agree to receive them in cash installments as they matured under the contract. He did nothing to charge himself with the economic benefit to be derived from the accruing commissions but, on the contrary, let them accumulate under an agreement whereby the company was to pay the same amount every month rather than constantly decreasing amounts.* (Emphasis supplied.)

We think the Tax Court shows sound basis for its reliance on *Oates*, convincingly pointing out its applicability here. Just as cogently has the Tax Court pointed out the insignificance of the distinguishing factors the Commissioner considers to be of importance. It said at pages 434-437 of 35 T.C.:

> Respondent seeks to distinguish the *Oates* case by arguing that in that case the contract was not transferable and the rights thereunder nonassignable, while here the petitioner's rights to the periodic payments were assignable. We cannot conceive what difference in principle this would make. Also in the *Oates* case the rights and interests under the contract were subject to assignment with the written consent of the insurance company, and a careful examination of the amendment to the general agent's contract indicates quite clearly that the periodic payments to the taxpayers were "subject to the rights of any assignee."
>
> Respondent also makes much of the testimony that Peoples was ready in December 1955 to pay the commuted value of the renewal commissions to petitioner in a lump-sum payment. The Executive Officer of Peoples testified that "We told him he could have it either way but we decided upon the annuity. We knew that Mr. Miller wanted to prolong his income." It would seem from this that Peoples decided upon the annuity. However, even if the choice were up to petitioner, it is clear that he had no right to demand cash as of December 1955. Nothing was due and payable at that time. The parties were simply bargaining for a suitable agreement and it is this agreement, which was bona fide and legally binding, that determined the rights of petitioner in 1956.
>
> Respondent seeks to distinguish the *Oates* case in that there the agency agreement was only amended while here it was extinguished and a new contract executed. Also in the *Oates* case the contract amendment merely bound the insurance company to pay the agents their renewal commissions (over 15 instead of 9 years) while here the new contract extinguished petitioner's old contract and gave the agent an annuity for 15 years.
>
> The contract amendment in the *Oates* case was virtually a new contract. We called it that in our opinion. In the affirming opinion in Commissioner [of Internal Revenue] v. Oates, supra, the court stated: "The amended contract was in the nature of a novation, that is, a substitution of a new agreement or obligation for an old one which was thereby extinguished." . . .
>
> The fact that here the new contract was an annuity and in the *Oates* case it was not, points up no difference that would warrant different tax treatment. In both, the deferred payments were computed to return to the agents their future renewal commissions. The only difference is that in the *Oates* case the company set up a renewal commission account for the agents on its books and made disbursements to the agents from these accounts. Here the company received the full renewal premiums without deduction for commissions and paid the agent what would be his commissions from its general funds. It is of passing interest to note the insurance official here testified Peoples actually did set up a ledger account of petitioner's renewals "just to see how we would come out on this thing" and he added "so far we are all right." . . .

What was said in *Motor Products Corporation*, supra, [1942, 47 B.T.A. 983, affirmed 6 Cir., 1944, 142 F.2d 449] can be said here. The insurance company's obligation to pay petitioner his future renewal commissions was the obligation of the old contract. When this was canceled and the new contract executed the insurance company had substantially the same obligation to pay the same party the same amounts of the agent's commissions on future renewals. The only change here was the change in payment dates which, as held in the cited cases, is immaterial on the issue we are considering.

We hold there is no significant difference in the facts between this case and the *Oates* case and the same rule applies, to wit: The periodic payments are taxable to petitioner as ordinary income under the annuity contract when and if received. There was no "sale or other disposition" of the agent's right to renewals under the agency contract within the meaning of section 1001(b), I.R.C. 1954, and petitioner realized no gain taxable under said statute.

We agree with the Tax Court in its conclusion that there was no "sale or other disposition" within the meaning of Section 1001, and that the new contract merely provided for a different rate or manner of payment whereby the insurance company could discharge its liability under its agency contract.

The Commissioner's alternative argument here is that even if there is found to be no sale or other disposition within the meaning of Section 1001, this is an annuity contract and that to the extent of its fair market value, such contract constituted gross income to the respondent under the provisions of Section 61. In support of his argument, the Commissioner cites Oberwinder v. Commissioner, 1945, 147 F.2d 255, a case from the Eighth Circuit, as controlling. He also lists United States v. Drescher, 2 Cir., 1950, 179 F.2d 863, certiorari denied 340 U.S. 821; Hackett v. Commissioner, 1 Cir., 1946, 159 F.2d 121; Hubbell v. Commissioner, 6 Cir., 1945, 150 F.2d 516; Percy S. Lyon, 1954, 23 T.C. 187; and Renton K. Brodie, 1942, 1 T.C. 275, as clearly establishing "that receipt of a valuable commercial annuity contract in lieu of compensation (or in lieu of renewal commissions, as in the case at bar) is the equivalent of cash for tax purposes and constitutes taxable income in the year of receipt, to the extent of the fair market value thereof." However, analysis of those cases points up that the court, in each, relied upon a factor absent herein — in each of those cases an employer had paid out, and deducted for that year, money to an insurance company for an annuity for the employees as added compensation. The courts there held that the amount paid out in that year was for the benefit of the employee, and therefore the employee was taxable to that extent, though he had not yet received any payment under the annuity. In the case before us, there is, of course, no payment made by Peoples, no deduction claimed by Peoples, no intended compensation from Peoples to the taxpayers for employment other than what had already been earned. There is, on the other hand, consideration running both ways in that Peoples obtained a cancellation of the exclusive territorial contract held by respondent, as well as respondent's promise to sell for no one but Peoples in the State of Iowa, and respondent received the new contract with its payments distributed evenly over a fifteen-year period. All that was intended here, as found by the Tax Court, was to substitute one contract for another — in other words, a novation. At no time was respondent in a position to demand more than the stipulated monthly payments. It did not reduce future payments to possession. It did not assign the contract. It did nothing to indicate it had assumed dominion over the installments to be made in the future.

We hold with the Tax Court that this cash basis taxpayer is to be taxed only on the payments as it receives them in accordance with the new agreement.

Affirmed.

NOTE

1. *Sale vs. novation.* The Tax Court found that the taxpayer was on the cash basis of accounting. Was this relevant to the outcome of the case? See page 783 infra. Did the government's case rest on the fact that the 1955 contract was called an "annuity" by the parties and called for payments by a life insurance company? Assume that a client owes a law firm $10,000 for services rendered, and that they subsequently agree that payment shall be made at the rate of $2500 annually for four years. Would a government victory in the *Olmsted* case have required this arrangement to be treated as a taxable disposition of the original claim?

Would it have been appropriate to treat the *Olmsted* transaction as a "sale" by the taxpayer of a going business? What if the original contract had been assignable and the taxpayer had transferred its rights to a third party for $90,000, to be paid at the rate of $500 per month for 180 months?

2. *Securities: refunding operations and conversions.* The exchange of defaulted bonds for new instruments in a refunding operation is treated as a non-taxable event if the terms of the new bonds are substantially the same, except for the maturity date, as those of the surrendered bonds. West Missouri Power Co. v. Commissioner, 18 T.C. 105 (1952). and cases there cited. In a series of rulings, the Internal Revenue Service has also held that the exercise of a conversion privilege contained in convertible securities is a non-taxable event ("a transformation of the [securities] pursuant to a right contained therein rather than a disposition thereof"). Rev. Rul. 57-535, 1957-2 C.B. 513. These rules rest on the theory that there has been no sale or other disposition of the original securities (no "closed transaction"), rather than on any one of the many explicit "non-recognition" provisions (infra page 466) that are applicable to exchanges of corporate stock and securities. See also Regs. §1.1001-1(a), speaking of a conversion of property into cash or "the exchange of property for other property differing materially either in kind or in extent."

3. *Constructive receipt.* On the doctrine of constructive receipt, see pages 780 et seq. infra.

SECTION B. UNADJUSTED BASIS

Section 1012, providing that (unless otherwise provided) the basis of property shall be its "cost," is identical with §113(a) of the 1939 Code.

ALBANY CAR WHEEL CO., INC. v. COMMISSIONER
40 T.C. 831 (1963)

RAUM, Judge: On June 9, 1955, petitioner acquired by purchase the operating assets of a corporation [the "Old Company"] engaged in the business of manufacturing and selling chilled iron wheels. The Commissioner's adjustments here in issue relate to his reduction in the basis of the assets thus acquired, which in turn resulted in a disallowance of part of the cost of goods sold as well as in a reduction of the depreciation allowance. The total reduction in basis presently in dispute is $46,089.05.

The starting point in this case is Section 1012 of the 1954 Code which provides that "The basis of property shall be the cost of such property . . . [except in certain situations not applicable here]." Accordingly, the decisive question before us is: what did petitioner pay for the assets that it acquired from the Old Company?

According to the stipulation of facts and the evidence before us, petitioner paid $15,000 in cash on a note to the Old Company, and assumed certain specified liabilities of the Old Company in the net amount of $74,360.35. The Commissioner insists that the sum of these two figures, namely, $89,360.35, represents

the "cost" of the assets purchased. Petitioner, on the other hand, claimed a cost of $137,543.95, which was the book value of the assets in the hands of the Old Company. Petitioner undertook to support its higher cost basis by contending that, in addition to the foregoing $89,360.35 which it paid for the assets in the manner described, it also assumed an obligation of the Old Company for severance pay to its employees under a Union contract, that such obligation was equal to at least the difference between the $89,360.35 and the book value of the assets in the hands of the Old Company, and that it therefore represented an additional item of cost for the assets which it thus acquired. We disagree. We hold that although petitioner did in fact procure the cancellation of the Old Company's contingent liability in respect of severance pay by executing a new and different type of contract with the Union, petitioner's obligation under the new contract was of such contingent character that it could not be considered part of the cost of the assets which it acquired, and that any such obligation which might actually result in a fixed liability in a later year may properly be taken into account in petitioner's behalf as a deduction in such later year.

The Old Company's contract with the Union provided that, upon permanent closing of the plant, employees with from one to five years of service were to be allowed four weeks' severance pay and employees with five or more years of service were to be allowed eight weeks' severance pay. It had 111 employees in 1955, and when Cooley [taxpayer's president] was negotiating for the purchase of the assets, he was naturally concerned about any liability that might result in respect of severance pay, particularly since the chilled iron wheel industry was moribund. Indeed the evidence shows that he had calculations made showing that if the plant were to close at that time, the liability for severance pay would be approximately $48,000 in respect of the employees then working for the Old Company. Had the petitioner assumed fixed obligations in any such amount we would agree that such assumption would constitute a part of its cost of the assets acquired. But that is not what occurred.

In the first place, and perhaps of lesser importance, the Old Company's contract in respect of severance pay spelled out a liability to employees as of the time of closing. There was no liability for severance pay in respect of those employees who had died or who voluntarily terminated their employment.[1]

In the second place, and of greater significance here, petitioner did not assume the Old Company's liabilities in respect of severance pay. While it is true that Section XXII of petitioner's new agreement with the Union recites that "The Union recognizes that by entering into this Agreement the present Company has in effect assumed substantially the same obligations to the Union and to the employees as those which had been undertaken by the predecessor Company," the fact is that petitioner did not assume the Old Company's obligations and that its own obligations under the new contract were radically different from those of the Old Company.

Petitioner's obligations, set forth in Section XIV of the new contract, revolved primarily around notice. Under these provisions petitioner's liability to its employees at the time of permanent closing of the plant could be met by giving six weeks' written notice to employees with from one to five years of service and 12 weeks' written notice to employees with five or more years of service. Petitioner

1 Thus, of the 111 employees in 1955, only 58 remained in 1960 when the plant was actually closed, and if petitioner had in fact assumed the Old Company's obligations under the contract in force in 1955, its contingent liability in respect of the 111 employees would have become fixed only as to 58 of them. And of course, any liability to employees hired after petitioner began business could not properly be regarded as part of the cost of the assets acquired from the Old Company.

was liable for severance pay under the new contract only where it failed to give the specified notice. And the record shows that when petitioner in fact determined to close its plant in 1960 it gave the required notice to its employees. As a consequence, it paid their wages for work performed during the 6 or 12 week periods prior to closing, but they received no severance pay whatever. Those wages were deducted in petitioner's 1960 income tax return, in determining cost of goods sold in that year. Petitioner recognizes that it cannot have it both ways — i.e., it concedes that if it is entitled to have severance pay included as part of the cost of assets acquired in 1955, the deduction for wages paid in 1960 must be reduced by a like amount. However, we think that petitioner's method of reporting for 1960 was correct, that the wages paid in that year during the notice period prior to closing were properly deductible in 1960, and that they were not in any part a component of the "cost" of the assets acquired in 1955.

Of course, there was always the possibility that petitioner might become liable for severance pay, if, for example, the plant should burn down and the employees were thrown out of work without having received the required notice. But petitioner protected itself against this contingency by insurance, and the premiums paid therefor were plainly deductible as a business expense. We think that petitioner's liability for severance pay, in view of the notice provisions, was so speculative that its obligations under the Union contract cannot fairly be regarded as part of the "cost" of the assets acquired from the Old Company. To the extent that any liability might accrue in a later year as a result of that contract, payments thereunder may properly be taken into account at such later time; they may not be used to increase the cost of goods sold in an earlier year or to increase the amount of the depreciation allowance for such earlier year. . . .

NOTE

1. *Inclusion of indebtedness in cost basis.* Would the result have been different if the taxpayer had assumed its predecessor's obligations under the original contract? If it had assumed these obligations and then paid a lump sum to all of the employees to obtain a release of the assumed obligations? On acquiring its predecessor's business, the taxpayer agreed (as is not uncommon on the purchase of a going concern) to assume and pay the obligations listed in a schedule attached to the contract (trade accounts payable, accrued taxes and wages, etc., for which it received credit in computing its cost) as well as "all liabilities and obligations whether or not reflected on the books of the [Old Company] which may arise or have arisen from the operations of [its] facilities at [a named plant] up to the date of the closing." If the latter clause required the taxpayer to pay the claims of injured workmen, dissatisfied customers, etc., would the amounts claimed by the injured persons, the amounts actually paid, or the estimated settlement "value" of such claims be includible in the taxpayer's "cost" for the business? The contract also provided that the taxpayer was not to be liable for the Old Company's federal or state income taxes. If this provision, though binding between the parties to the contract, did not protect the purchaser against liability to the United States as "transferee" of the Old Company's assets (see p. 929 infra), could the taxpayer's potential liability to the United States for its predecessor's unpaid taxes be included in its "cost" if reimbursement by the predecessor was unlikely because of its absence from the jurisdiction, financial difficulties, or other cause?

In the *Albany Car Wheel Co.* case, the Internal Revenue Service itself acknowledged that the taxpayer's "cost" under §1012 included about $75,000 of specified liabilities that were assumed under the contract. Even if the taxpayer had not assumed these liabilities, they would be includible in its "cost" basis for the property if it had taken the property subject to them. See Parker v. Delaney, infra page 463 (taxpayer paid nothing for property, but took it subject to a mortgage; held, his "cost" was the amount of the mortgage).

It is not yet clear, however, whether the full amount of an unassumed liability enters into the taxpayer's cost if it exceeds the fair market value of the property.

2. *Purchase commissions.* For many years the Regulations have provided that commissions paid in purchasing securities are a part of the cost price of such securities. Regs. §1.263(a)-2(e). This provision of the Regulations was upheld in Helvering v. Winmill, 305 U.S. 79 (1938), against the contention of the taxpayer that the commissions were compensation for personal services deductible under §162(a)(1). The Court rested its decision largely on the fact that the provision was a long-standing administrative interpretation that presumably had received Congressional sanction. Even apart from the Regulations, should the commissions have been capitalized rather than deducted? What is the status of finders' fees, brokerage commissions, and similar expenses incurred in connection with other types of property? Should the salary of a corporate purchasing agent be capitalized as part of the cost of the materials he buys? If the president of a corporation spends part of his time planning and supervising the construction of a new plant, should an appropriate portion of his salary be capitalized instead of being deducted? See Rev. Rul. 59-380, 1959-2 C.B. 87, ruling that depreciation may not be taken on construction equipment employed in making capital improvements to the taxpayer's own property, and that the depreciation in question should be treated as part of the cost of the improvements, to be recovered by depreciating the improvements; cf. Great Northern Ry. Co. v. Commissioner, 30 B.T.A. 691 (1934) (contra).

3. *Inclusion of cost of collateral or related property.* If property is acquired by exercising an option, the transaction is not regarded as a taxable disposition of the option itself, but the "cost" of the property presumably includes both the cost (or other basis) of the option and the additional amount paid when it is exercised. Helvering v. San Joaquin Fruit & Investment Co., 297 U.S. 496 (1936) (alternative contention); Stires Corp. v. Commissioner, 28 B.T.A. 1 (1933). A somewhat analogous line of cases permits a taxpayer engaged in subdividing real property to include the cost of water and sewage systems in its basis for the buliding lots, even though these systems are not sold to the purchasers of the lots, if the systems are constructed to enhance the value of the lots and if the taxpayer's retained rights to the utilities are of minimal value or constitute a burden rather than a benefit. See Willow Terrace Development Co. v. Commissioner, 40 T.C. 689 (1963), and cases there cited.

4. *"Tax cost."* Property that is includible in the taxpayer's income on acquisition (e.g., stock received by an employee as compensation) is treated as having a "cost" equal to its fair market value at the time of acquisition (sometimes referred to as "tax cost"), at least if the taxpayer properly reported it. Even if he neglected to report it, however, there is authority for allowing him the benefit of the proper basis, since his use of this basis in the year the property is sold will ordinarily permit a deficiency to be assessed for the year of acquisition, despite the running of the statute of limitations, under §§1311-1315. See Bennet v. Helvering, infra page 869; Regs. §1.1312-6, Example (1)(ii). Query: what is the basis of property received as compensation that was not includible in income when acquired because the taxpayer was then a nonresident alien, or that was acquired when the taxpayer was entitled to the $20,000 or $25,000 exclusion of §911(a) (bona fide residence or extended physical presence in a foreign country)?

The property's "cost" may be a combination of a cash outlay and an amount included in income: e.g., when the taxpayer in the *LoBue* case, supra page 41, sells his stock, its basis will be his cash outlay plus the "spread" at the time the option was exercised.

5. *Property acquired by relinquishing a claim.* In the *Davis* case, supra page 432, the Court held that Mrs. Davis' basis for the shares transferred to her was their market value. This conclusion evidently did not rest on the assumption that the shares were includible in *her* income on acquisition, thus giving her a "tax cost"; instead, the Court seems to regard the value of the marital rights she surrendered to acquire the stock as her cost, and to derive the value of the rights by looking to the value of the stock, in keeping with its theory that the rights and the shares can be assumed to be equal in value. See also *Farid-es-Sultaneh,* supra page 133. The same approach would seem appropriate in determining the basis of property acquired in settlement of a claim for personal injury, if the value of the taxpayer's rights is not susceptible to direct measurement and he has no "tax cost" because the property is not includible in income upon acquisition.

6. *Exchange of properties of unequal value.* In the *Davis* case, the Court used the value of the stock to ascertain the "amount realized" by Mr. Davis (i.e., the value of the marital rights): "Absent a readily ascertainable value it is accepted practice where property is exchanged to hold, as did the Court of Claims in Philadelphia Park Amusement Co. v. United States . . . that the values 'of the two properties exchanged in an arm's length transaction are either equal in fact, or are presumed to be equal.'" But what if both properties have a readily ascertainable value, and their values are unequal? Consider these possibilities:

(a) A exchanges property worth $100,000 for stock worth $75,000 but falsely represented as worth $100,000.

(b) B exchanges property worth $100,000 for stock that is worth $100,000 to him (because when added to other shares he already owns, it will give him control of a corporation), but that is worth only $75,000 to other persons (using stock market quotations to determine value).

(c) C exchanges property worth $100,000 for real estate worth $75,000, the excess being paid because the property is his family's ancestral home or because he wants to forestall Negro occupancy.

Would the "cost" of the properties in the foregoing cases be $100,000 or $75,000? If the latter, could the $25,000 "gap" be reflected for tax purposes in any way? Would the result be different if in each case the taxpayer had paid $100,000 in cash for the property, rather than exchanging other property?

There may be a disparity in values when properties are exchanged because the transaction is not "merely" an exchange. Thus A may exchange property worth $100,000 for property worth $75,000 because he wishes to make a gift of the difference to the transferee. For the effect of such a part-sale-part-gift, see Regs. §1.1001-1(e) (transferor's gain or loss) and §1.1015-4 (basis to transferee). Taxpayers sometimes sell appreciated property to charities for an amount equal to the property's adjusted basis (thus avoiding the recognition of gain), and deduct the excess of value over the sales proceeds as a charitable contribution. See Potter v. Commissioner, 38 T.C. 951 (1962). There are a number of other situations in which property is sold or exchanged for less than its fair market value: the "spread" may be an indirect method of compensating an employee, paying a dividend to a shareholder, making a contribution to the capital of a corporation, settling a family dispute, paying a business debt, etc.

7. *Identification of property sold.* If the taxpayer owns fungible property that was acquired in separate lots at different times and prices, how is his gain or loss (and, when relevant, his holding period) on a sale of the property to be determined? If the property is includible in inventory (e.g., merchandise held for sale to customers in the ordinary course of business), the taxpayer's inventory method will be controlling; ordinarily, gain or loss will be computed on the assumption that the items acquired first are sold first ("FIFO"), but some other method of matching costs against receipts may be applicable. (See page 811 infra.) If the property is not includible in inventory (e.g., securities held by an investor), the taxpayer may pick and choose among his certificates and thus control, within limits, the tax consequences of a sale. If he cannot adequately identify the certificates delivered for sale, however, his basis and holding period are to be determined on the first-in-first-out principle. Regs. §1.1012-1(c); see also Haynes v. Commissioner, 17 T.C. 772 (1951). Sometimes stock acquired at different times or prices is represented by a single certificate, because the original certificates were surrendered in a merger, destroyed by fire and replaced by the corporation, etc. In such cases, it is not clear whether a taxpayer who can establish the facts may announce that he is selling shares acquired at one price rather than those acquired at a different price. Compare Bloch v. Commissioner, 148 F.2d 452 (9th Cir. 1945), with Fleischmann v. Commissioner, 40 B.T.A. 672 (1939); see also Rev. Rul. 56-653, 1956-2 C.B. 185. It is also unclear in such cases whether, when identification is impossible, the cost of the shares sold is to be determined on the first-in-first-out or the average cost principle. See Arrott v. Commissioner, 136 F.2d 449 (3rd Cir. 1943); but cf. Curtis v. Helvering, 101 F.2d 40 (2d Cir. 1939). See also Regs. §1.1012-1(c)(3) and Rev. Rul. 61-97, 1961-1 C.B. 394, providing that adequate identification is made when a taxpayer directs a broker who holds securities for him to sell specific shares and receives confirmation from the broker; and Regs.

§1.1012-1(c)(4), providing that a fiduciary who holds shares with different bases and holding periods may preserve these characteristics for the distributees by appropriate red tape, regardless of what certificates are actually distributed. See Colgan, Identification of Securities Sold or Transferred, 18 N.Y.U. Inst. on Fed. Taxation 323 (1960).

8. *Allocation of basis.* Property is often acquired in a single transaction but disposed of piecemeal. When this occurs, the cost (or other basis) for the whole must be allocated among the parts. A common example is the subdivider who acquires a large tract of land and sells off small lots; he must allocate his cost among the lots in proportion to their market values. If the lots are fungible, the allocation may be based on size alone, but location or other elements of value may require the cost to be allocated in a different manner, and resort may be had to assessments, appraisals, purchase offers, resale prices of similar property, etc., in establishing the proper allocation. The relative values are to be determined as of the date of acquisition, disregarding later shifts in relative values; the cost of later improvements that benefit the entire tract, however, might have to be allocated in a different proportion from the original cost, if the separate lots do not receive the same relative benefit from the improvements. See Fairfield Plaza, Inc. v. Commissioner, 39 T.C. 706 (1963); Ayling v. Commissioner, 32 T.C. 704 (1959); Regs. §1.61-6(a). Another common example of the allocation of the taxpayer's cost basis is the acquisition of a going business for a lump sum; see discussion in the note following Williams v. McGowan, infra page 570.

If the taxpayer sells a partial interest in property and cannot establish a reasonable method of allocating his basis, is the entire amount received taxable because the relinquished interest has no basis, or is it a return of capital, taxable only to the extent that it exceeds the basis of the entire property? See Inaja Land Co. v. Commissioner, supra, page 68; but query the result if the taxpayer had sold the land, retaining only the right to fish; see also Black v. Commissioner, 38 T.C. 675 (1962).

If property that has been acquired piecemeal is sold in a single transaction, it will ordinarily not matter whether gain and loss is computed item by item or for the lot as a whole. Where a difference would arise (e.g., if the capital gain and loss provisions are applicable and the items have different holding periods; or if the buyer is a related person so that losses are non-deductible under §267(a)(1) but gains are taxable, supra page 415), it is necessary to apply §1001 to the individual items separately. In Paul v. Commissioner, infra page 591, the theory of separate transactions was applied to the sale of a recently constructed building, the taxpayer being allowed to show that part of his gain was attributable to construction more than six months before the sale, so as to report long-term rather than short-term capital gain on that part of his profit.

9. *Basis other than cost.* There are many exceptions to the general principle, embodied in §1012, that the basis of property is its "cost." If a taxpayer sells a residence at a profit and buys a second residence within a year of the sale, the basis of the second residence is determined by reference to the basis of the first rather than solely by its cost, infra page 473; and a "substituted basis" * is similarly employed if the taxpayer acquires property to replace other property lost by an involuntary conversion (fire, theft, condemnation, etc.), infra page 471, if he engages in a "wash sale," see §1091(d), or if he exchanges property for other property of a like kind in a transaction meeting the requirements of §1031. The Code also prescribes a basis for property that has no "cost," e.g., property acquired from a donor or a decedent, §1015 and §1014, supra pages 102 and 146.

See also page 245 supra for the basis of property acquired for personal use and subsequently converted to a business purpose; and §1053, for the basis of property acquired before March 1, 1913.

Special basis rules are also applicable to many transactions involving the organization, reorganization, and liquidation of corporations; see generally Chapter VII.

10. *Reference.* Greenbaum, The Basis of Property Shall Be the Cost of Such Property: How Is Cost Defined? 3 Tax L. Rev. 351 (1948).

* For this term, see §1016(b).

Section C. Adjusted Basis

Section 1016, providing that the basis of property shall be adjusted for improvements, depreciation, etc., is identical in basic principle with §113(b) of the 1939 Code, but there are some differences in detail.

COMMISSIONER v. SUPERIOR YARN MILLS, INC.
228 F.2d 736 (4th Cir. 1955)

Before Parker, Chief Judge, Soper, Circuit Judge, and Bryan, District Judge.

Bryan, District Judge.

On its petition for a redetermination of deficiency assessments of income and excess profits taxes for 1944, 1945 and 1946, Superior Yarn Mills, Inc. has been allowed by the Tax Court to increase from $243,000 to $316,000 — an added $73,000 — the sum originally allocated by the taxpayer as the cost basis of the depreciable items of the plant it purchased in 1929 for $500,000. In framing an order to effectuate the Tax Court's conclusion, under its Rule 50, 26 U.S.C. §7453, the Commissioner of Internal Revenue insisted that for use in 1944 the new cost base must be adjusted by deduction of the amount of depreciation theretofore allowed for the period 1929 to 1944, as well as of the sum allowable over the same years for depreciation on the cost-accession [$73,000]. Contra, the taxpayer contended that to find the adjusted cost basis for 1944, the only depreciation deductible was the amount which had actually been allowed for the 1929-1944 depreciation — that no deduction could be made in those years for depreciation of the [$73,000] increment.

[Somewhat simplified, the facts were: In 1929, the taxpayer paid $500,000 for an industrial plant (consisting of machinery, buildings, water power equipment, land, and certain riparian rights to use the water of an adjacent river for power). In 1934, it allocated this payment among the constituent assets, assigning $243,000 to the depreciable property. In 1945, on the basis of a report by a tax consultant, the taxpayer reallocated the original cost of $500,000, assigning about $485,000 to the depreciable property. The taxpayer used the 1945 allocation in computing its 1944-46 depreciation deductions, as well as in computing losses on abandonment of certain of the depreciable assets in the years 1944-1946. The Internal Revenue Service asserted deficiencies for 1944-1946 based on use of the 1934 allocation. The Tax Court rejected both allocations, and held that about $316,000 of the $500,000 cost should have been assigned in 1929 to the depreciable assets.

[Having held that the cost, or unadjusted basis, of the depreciable assets was $316,000, the Tax Court then held that their adjusted basis as of 1944 was this amount less the depreciation deducted during the period 1929-1943. The taxpayer and the government accepted the Tax Court's determination of cost (i.e., $316,000), but the government appealed on the ground that this amount should be reduced by the depreciation that would have been deducted if the proper allocation had been made in 1929. After holding that the government had not waived this point by failing to raise it before the Tax Court at the proper time, the court addressed itself to the substantive issue.]

II. The Tax Court has held that the new cost base could not be made effective from 1929 for computing depreciation, but that it was usable for that purpose only for 1944 and later years. This meant that the old cost figure would be the basis for ante-1944 depreciation and that no depreciation was "allowable" from

1929 to 1944 against the addition [$73,000] made to the cost in the new base. The Court reasoned that "not having been known, the bases may not be revised by a retroactive application of the Court's decision." Related to this conclusion of the Court are two of the propositions pressed by the taxpayer. Superior contends that it should not be charged with depreciation on the increase prior to 1944 because the increase was not then known, and for this argument, it draws on the implication of Treasury Regulations [§1.1016-3(a)(1)(ii)], to the effect that a taxpayer is held to allowable depreciation, if exceeding the allowed, only when the allowability appears from "facts reasonably known to exist at the end of such year or period." The taxpayer's other proposition is that the Tax Court cannot depreciate the increase during 1929-44 for that would constitute forbidden retroactive depreciation.

The duty of the Tax Court on the petition for redetermination was to declare the adjusted cost bases for 1944-46, respectively. In so doing it was bound to adhere to the statute and regulations. As we see it, the statute required the Court to start with the original cost; and the regulations required, in the circumstances here, that the cost "should be the value of the depreciable property at the time of acquisition." Thereafter, the statute directed, the original cost must be reduced by the aggregate annual depreciation allowed, not less than the allowable. The failure of the Tax Court in this instance to carry the new cost base back to 1929 and adjust it by subtraction of the depreciation allowable from then until 1944, was error, a violation of the statute and regulations. Blackhawk-Perry Corp. v. Commissioner, 8 Cir., 1950, 182 F.2d 319, certiorari denied 340 U.S. 875.

True, the new 1929 base was not declared in any year prior to 1945, but that is no reason for not making it effective as of 1929. No matter when found, it is still the 1929 base, and must be subjected to the depreciation of subsequent years.

Irrespective of its power, the Tax Court has not been asked to apply depreciation retroactively. That process connotes the application to earlier years of a rate affected by conditions of a later date. Here the process will involve a contemporaneous rate contemporaneously applied. Having found the 1929 cost basis, the Court should for that, and every year thereafter through 1946, ascertain, as of the end of each year, what amount represents the exhaustion for such year, using a rate determined by the conditions prevalent in that year. The new 1929 cost basis will in this manner be downgraded annually for wear and tear and the remaining unrecovered cost will be the adjusted cost basis. If this be depreciating retroactively, it is nevertheless valid, for it is the prescription of the statute and regulations.

Taxpayer dubs this procedure as hindsight calculation, said to be unacceptable in taxation. As just explained, we do not think it can be so impugned. But it was the taxpayer who first invoked the Tax Court's hind-vision; it asked the Court to revert to 1929 and enlarge the 1929 cost base. More, Superior candidly concedes in its brief that the Government could have "raised the issue as to prior year allowable depreciation upon the trial of this case or upon a duly granted motion for rehearing"—seemingly a concession that prior allowable depreciation was a subject justiciable by the Tax Court.

The resulting hybrid adjusted basis exposes the frailty of the Tax Court's conclusion. One portion of the value in each item of the properties would be depreciated, while the remaining value therein would be undepreciated. Besides, it is contrary to reality—a touchstone in taxation—since the increment, in truth, was not preserved intact until 1944 but suffered depreciation in the same degree and at the same time as did the original valuation.

Both the Tax Court and the taxpayer feel their reciprocal and complementing

positions — that the new base cannot be used as the depreciation multiplicand in the 1929-1944 period and that the increment of cost is not depreciable earlier than 1944 — are precedented by such decisions as Sample-Durick Co. Inc., 35 B.T.A. 1186; Commissioner v. Mutual Fertilizer Co., 5 Cir., 159 F.2d 470; and Commissioner v. Cleveland Adolph Mayer Realty Corp., 6 Cir., 160 F.2d 1012. These cases only declare that the annual rate of depreciation must be fixed on the strength of circumstances obtaining before and during the year of the charge, and that, once so fixed for any year or period of years, the rate cannot be changed retroactively by an alteration in the estimated life of the property. But this is not to say that original cost cannot in a subsequent year be determined from conditions existing in the year of acquisition, and then be used as the cost in reaching an adjusted base; if it were, then original cost could never be ascertained in the years following. Adding to the cost base, through recalculation of it as of the time of acquisition, is not a modification of the estimated life of the property. Furthermore, the very nature of original cost renders any subsequent change in it a retroactive change.

III. No inequity is imposed upon the taxpayer by relating the new cost basis to 1929 for purposes of adjustment. If, as Superior complains, it has not received the credits to which it would have been entitled, for the depreciation to be charged to the new increment of cost, and is prevented now by time limitations from procuring the credits,* the ready response is that the taxpayer will, nevertheless, profit by the increase of the cost base and it must accept the burdens with the benefits. The taxpayer and not the Government was responsible for the lapse of the opportunity to claim the credits; not until 1945 did the taxpayer ask for the increase in cost.

Superior contends that it claimed, but was refused, a depreciation greater than was allowed each year from 1929 to 1944. Accordingly, it denounces as unfair the enforcement now by the Commissioner of any assessment which penalizes the taxpayer by charging allowable but not allowed depreciation. Perkins v. Thomas, 5 Cir., 1936, 86 F.2d 954. Though not clear with respect to the years 1929 to 1932, inclusive, the record discloses no refusal by the Commissioner to accord the taxpayer every depreciation allowance requested from 1933 to 1944. Of course, this position of the taxpayer is at odds with its contention that the depreciation now asked by the Commissioner should not be charged because it was not known in the period 1929-44. Obviously, too, the taxpayer did not previously seek the depreciation now asserted by the Commissioner, for the increment was not established for 1929 until 1945. The taxpayer also protests that it has never been heard by the Tax Court on whether the allowed depreciation was not in fact actually the equivalent of the allowable deduction from 1929 to 1944. An opportunity to be heard on both of these grievances, if such they be, will be afforded the respondents in the Tax Court under the terms of our remittitur.

We hold that the [$73,000] increase placed by the Tax Court upon the 1929 cost of depreciables . . . must be depreciated annually from that year through the tax years. Therefore, we reverse the decision of the Tax Court and remand the case to it for a redetermination of the taxpayer's liability. The redetermination should be made in the light of our decision on depreciation and upon consideration of the taxpayer's contentions, if sustained in the evidence upon further

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* On the possibility of opening up the pre-1944 returns, despite the running of the statute of limitations, see §§1311-1315, infra page 877; query whether the taxpayer's failure to deduct as much depreciation as was proper constituted an "erroneous inclusion in gross income" within the meaning of §1312(7)(C)(i) that will permit the old returns to be reopened. In any event, §1314(d) forbids opening up pre-1932 returns. — Ed.

hearing, that in prior years taxpayer was refused greater depreciation than has been taken, and that, even with the [$73,000] increment included, the sums already deducted for depreciation represent all the depreciation chargeable against the exhaustible property.*

Reversed and remanded.

PARKER, Chief Judge (dissenting).

I think that the decision of the Tax Court should be affirmed for reasons adequately stated in its opinion. The question before that court was the proper allocation between depreciable and non-depreciable assets of the price of $500,000 paid for the property in 1929. This was not a matter readily determinable, like the price paid for a piece of machinery, but rested largely in opinion. The valuation of $243,000 placed upon the depreciable assets in 1934 was found by the Tax Court to be too low after the abandonment of the water power in 1945; and that court after a careful hearing found that the depreciable assets at the time of their purchase in 1929 had a value of $316,000. In the meantime taxpayer had been taking depreciation on only $243,000, or depreciation considerably less than would have been taken on the basis of $316,000.

The question here involved is not the simple one of valuing the property as of 1944 but whether, when it is valued as of 1929, it should be depreciated for the intervening years in the full amount allowable on that valuation or in the amount actually allowed, which was the maximum then allowable on the existing valuation. If depreciated for the intervening years on the full 1929 valuation as made in 1944, taxpayer will lose the benefit of depreciation to which it is justly entitled, as it cannot go back and amend its returns. If depreciated in accordance with the amount of depreciation actually allowed during the intervening years, the value added by the reappraisal will be depreciated through the remaining life of the property, which will result in substantial justice, even though there is a "bunching" of depreciation on the added value in the remaining years. The real question then is whether the right to this depreciation has been permanently lost to the taxpayer or whether the increased value found by the Tax Court may be depreciated through the remaining life of the property. It seems clear to me that the Tax Court has given the correct answer to this question.

A change in original valuation based on fuller knowledge of the facts should no more be made retroactive for purposes of computing depreciation than a change of depreciation rate based on fuller knowledge. As said by the Court of Appeals of the Sixth Circuit in Commissioner v. Cleveland Adolph Mayer Realty Corp., 160 F.2d 1012, 1015, a case involving a change in the depreciation rate: "And if depreciation is to be taken each year, it must perforce be taken upon the basis of the understanding of value, existing at that time (at the end of the accounting period), and not, as has been said, in the light of 'hindsight.'" See also Commissioner v. Mutual Fertilizer Co., 5 Cir., 159 F.2d 470, 471 which quotes [Regs. §1.1016-3(a)(1)(ii)] providing "The determination of the amount properly allowable shall, however, be made on the basis of facts reasonably known to exist at the end of such year or period." . . .

NOTE

1. *Adjustment to basis for depreciation.* As the *Superior Yarn* case illustrates, the taxpayer's basis must be adjusted (downward) for depreciation that was "allowable," whether it was in fact deducted or not. Note that §1016(a)(2) (second sentence) provides for the use of the straight-line method of computing depreciation if the taxpayer neglected to

* The proceedings on remand are not reported. — ED.

adopt a method. If the taxpayer deducted more depreciation than was allowable, the full amount "allowed" (i.e., deducted and not disallowed) must be applied against his basis except to the extent that the excess was of no "tax benefit." See §1016(a)(2)(B), overruling Virginian Hotel Corp. v. Helvering, 319 U.S. 523 (1943), which had held that basis must be reduced by the full amount of depreciation deducted by the taxpayer even though the excess over the amount properly "allowable" produced no tax benefit.

2. *Adjustments for items chargeable to capital account.* Under §1016(a)(1), the property's basis is adjusted (upward) for the cost of capital improvements and similar items chargeable to capital account. An adjustment is explicitly forbidden by §1016(a)(1)(A), however, if the taxpayer elected to deduct taxes or other carrying charges that would otherwise have been capitalized; and other subsections of §1016(a) similarly forbid adjusting the basis of property for a variety of other items that the taxpayer elected to deduct, such as research and experimental expenditures, circulation expenditures, and expenditures for the exploration and development of mines. If a taxpayer erroneously deducts an item that should be capitalized (e.g., by classifying an expenditure as a deductible repair rather than an improvement), may he later add the same expenditure to basis? Note that §1016(a)(1) speaks of amounts "properly" chargeable to capital account, that Regs. §1.1016-6(b) provides that "the principles of estoppel" apply in determining basis and adjustments to basis, and that §1312(7)(C)(iii) would ordinarily permit the earlier year to be reopened, despite the statute of limitations, for the purpose of disallowing the erroneous deduction under §1311.

Section 1016(a)(1) also requires receipts, losses, and other items, as well as expenditures, to be taken into account if properly chargeable to capital account. Under this provision, the Inaja Land Company, supra page 68, would have to reduce its basis for its property from $61,000 to $11,000 to reflect the $50,000 received from the city of Los Angeles; a taxpayer whose property is partly damaged by casualty would reduce his basis by the amount of the deductible casualty loss; and a taxpayer who writes off property as worthless must reduce its basis to zero. If the taxpayer derived no "tax benefit" from the write-off, however, it is possible that his basis will remain intact. See page 867 infra.

3. *Other adjustments.* Many other adjustments to basis are required by §1016, including a reduction in the basis of stock if the shareholder received a tax-free distribution, an increase in the basis of commodities pledged for a federal price support loan if the taxpayer elects under §77 to treat the amount of the loan as income, supra page 441, and a reduction in the basis of property if the taxpayer elects under §108, supra page 93, not to recognize income on the discharge of indebtedness for less than its face amount.

4. *"Recomputed basis."* With the enactment of §1245 in 1962, a new concept — "recomputed basis" — entered the Code. Its meaning and function are considered infra pages 561 et seq.

Section D. Amount Realized

Section 1001(b), providing that the "amount realized" from a sale or other disposition of property shall be the sum of any money received and the fair market value of other property, is identical with §111(b) of the 1939 Code.

BURNET v. LOGAN

283 U.S. 404 (1931)

Mr. Justice McReynolds delivered the opinion of the Court.

These causes present the same questions. One opinion, stating the essential circumstances disclosed in No. 521, will suffice for both.

Prior to March, 1913, and until March 11, 1916, respondent, Mrs. Logan, owned 250 of the 4,000 capital shares issued by the Andrews & Hitchcock Iron Company. It held 12% of the stock of the Mahoning Ore & Steel Company, an operating concern. In 1895 the latter corporation procured a lease for 97 years upon the "Mahoning" mine and since then has regularly taken therefrom large,

but varying, quantities of iron ore — in 1913, 1,515,428 tons; in 1914, 1,212,287 tons; in 1915, 2,311,940 tons; in 1919, 1,217,167 tons; in 1921, 303,020 tons; in 1923, 3,029,865 tons. The lease contract did not require production of either maximum or minimum tonnage or any definite payments. Through an agreement of stockholders (steel manufacturers) the Mahoning Company is obligated to apportion extracted ore among them according to their holdings.

On March 11, 1916, the owners of all the shares in Andrews & Hitchcock Company sold them to Youngstown Sheet & Tube Company, which thus acquired, among other things, 12% of the Mahoning Company's stock and the right to receive the same percentage of ore thereafter taken from the leased mine.

For the shares so acquired the Youngstown Company paid the holders $2,200,000 in money and agreed to pay annually thereafter for distribution among them 60 cents for each ton of ore apportioned to it. Of this cash Mrs. Logan received 250/4000ths — $137,500; and she became entitled to the same fraction of any annual payment thereafter made by the purchaser under the terms of sale.

Mrs. Logan's mother had long owned 1100 shares of the Andrews & Hitchcock Company. She died in 1917, leaving to the daughter one-half of her interest in payments thereafter made by the Youngstown Company. This bequest was appraised for federal estate tax purposes at $277,164.50.

During 1917, 1918, 1919 and 1920 the Youngstown Company paid large sums under the agreement. Out of these respondent received on account of her 250 shares $9,900.00 in 1917, $11,250.00 in 1918, $8,995.50 in 1919, $5,444.30 in 1920 — $35,589.80. By reason of the interest from her mother's estate she received $19,790.10 in 1919, and $11,977.49 in 1920.

Reports of income for 1918, 1919 and 1920 were made by Mrs. Logan upon the basis of cash receipts and disbursements. They included no part of what she had obtained from annual payments by the Youngstown Company. She maintains that until the total amount actually received by her from the sale of her shares equals their value on March 1, 1913, no taxable income will arise from the transaction. Also that until she actually receives by reason of the right bequeathed to her a sum equal to its appraised value, there will be no taxable income therefrom.

On March 1, 1913, the value of the 250 shares then held by Mrs. Logan exceeded $173,089.80 — the total of all sums actually received by her prior to 1921 from their sale ($137,500.00 cash in 1916 plus four annual payments amounting to $35,589.80). That value also exceeded original cost of the shares. The amount received on the interest devised by her mother was less than its valuation for estate taxation; also less than the value when acquired by Mrs. Logan.

The Commissioner ruled that the obligation of the Youngstown Company to pay 60 cents per ton had a fair market value of $1,942,111.46 on March 11, 1916; that this value should be treated as so much cash and the sale of the stock regarded as a closed transaction with no profit in 1916. He also used this valuation as the basis for apportioning subsequent annual receipts between income and return of capital. His calculations, based upon estimates and assumptions, are too intricate for brief statement.* He made deficiency assessments according

* The government placed a value on the Youngstown contract by estimating the total amount of ore in the Mahoning mine as 82.9 million tons, of which about 10 million tons (12 per cent) was allocable to Youngstown; at 60 cents per ton, Youngstown would be required to pay a total of about $6 million. On the assumption that this amount would be paid in equal installments over a period of 45 years — the life of the mine, as estimated by the government — the 1916 value of the future payments was calculated as about $1.9 million.

The "amount realized" by the shareholders of Andrews & Hitchcock was thus, on the government's theory, $4.1 million ($2.2 million in cash plus $1.9 million in the form of a promise), or about $1035 per share. The Court was not called upon to pass on the tax consequences in 1916

to the view just stated and the Board of Tax Appeals approved the result. The Circuit Court of Appeals held that, in the circumstances, it was impossible to determine with fair certainty the market value of the agreement by the Youngstown Company to pay 60 cents per ton. Also, that respondent was entitled to the return of her capital — the value of 250 shares on March 1, 1913, and the assessed value of the interest derived from her mother — before she could be charged with any taxable income. As this had not in fact been returned, there was no taxable income.

We agree with the result reached by the Circuit Court of Appeals.

The 1916 transaction was a sale of stock — not an exchange of property. We are not dealing with royalties or deductions from gross income because of depletion of mining property. Nor does the situation demand that an effort be made to place according to the best available data some approximate value upon the contract for future payments. This probably was necessary in order to assess the mother's estate. As annual payments on account of extracted ore come in they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was $2,200,000.00 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921 all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

"In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration." Doyle v. Mitchell Bros. Co., 247 U.S. 179, 184, 185. Ordinarily, at least, a taxpayer may not deduct from gross receipts a supposed loss which in fact is represented by his outstanding note. Eckert v. Commissioner of Internal Revenue, 283 U.S. 140. And, conversely, a promise to pay indeterminate sums of money is not necessarily taxable income. "Generally speaking, the income tax law is concerned only with realized losses, as with realized gains." Lucas v. American Code Co., 280 U.S. 445, 449.

From her mother's estate Mrs. Logan obtained the right to share in possible proceeds of a contract thereafter to pay indefinite sums. The value of this was assumed to be $277,164.50 and its transfer was so taxed. Some valuation — speculative or otherwise — was necessary in order to close the estate. It may never

of the government's theory that there was a "closed transaction" in that year; the taxpayer would evidently have incurred a loss on the government's theory, since the "amount realized" for her 250 shares was less than their value as of March 1, 1913. (Section 5(a)(4) of the Revenue Act of 1916, unlike §1053 of the 1954 Code, provided that the 1913 value of property acquired before that date was its basis for computing loss as well as gain.) Consistently with its theory that the transaction was closed in 1916, the government conceded that the taxpayer was entitled to treat part of each payment received by her from Youngstown as a return of her investment in the contract, i.e., the 1916 value of her interest in the contract. This allowance was effected by amortizing the 1916 value of the contract over its 45-year estimated life, with the result that the net income would be the difference between the aggregate amount received by her from Youngstown and the 1916 value of the contract. (In the case of the contract inherited from her mother, the amount to be amortized was $277,164, its value for estate tax purposes.) — Ed.

yield as much, it may yield more. If a sum equal to the value thus ascertained had been invested in an annuity contract, payments thereunder would have been free from income tax until the owner had recouped his capital investment.* We think a like rule should be applied here. The statute definitely excepts bequests from receipts which go to make up taxable income. See Burnet v. Whitehouse, 283 U.S. 148.

The judgments below are affirmed.

NOTE

1. *Inability to establish fair market value.* According to Regs. §1.1001-1(a), "only in rare and extraordinary cases will property be considered to have no fair market value." In Helvering v. Walbridge, infra page 752, Judge L. Hand expressed the view that fair market value "is not nearly so universal a phenomenon as to justify such a comment." Is the approach of the Supreme Court in the *Davis* case, where the value of the marital rights received was determined by looking to the value of the stock exchanged on the assumption that their values were equal, in harmony with the result in Burnet v. Logan? Does the case rest on an assumption that *neither* the stock surrendered by the taxpayer *nor* the rights received by her could be valued?

For the possibility that payments may be classified as capital gain rather than ordinary income if the transaction from which they stem is not "closed," see page 649 infra.

2. *Relation of "amount realized" to taxpayer's accounting method.* The impact of the taxpayer's accounting method on the "amount realized" is quite murky. A merchant will ordinarily accrue his accounts receivable at face value, and either set up a bad debt reserve for uncollectible accounts or write off such accounts as they go sour. In the case of a casual sale, not in the ordinary course of business, however, a claim against the buyer is ordinarily not taken into income until payment, at least if the taxpayer is on the cash basis of accounting and the claim is non-negotiable. Infra page 816. If the taxpayer in Burnet v. Logan was on the cash basis, this might have afforded an alternative basis for decision.

3. *Settlement of debt as "amount realized."* It has already been noted, supra page 438, that the transfer of property in satisfaction of a debt is a taxable event. If the amount owing is in dispute, however, what is the "amount realized"? In United States v. Hall, 307 F.2d 238 (10th Cir. 1962), involving a taxpayer who transferred property worth $150,000 in settlement of a gambling debt variously estimated to be between $145,000 and $478,000, the court held that the taxpayer's gain on the property should be computed as though it had been sold for cash and the proceeds had been paid to the winner; the debt being unenforceable under state law, the court held that the excess (if any) of the debt over the value of the property was not taxable income. What if the taxpayer in the *Bradford* case, supra page 89, had discharged her liability to the bank by transferring stock with a basis of $20,000 and a fair market value of $50,000?

4. *Services as the "amount realized."* Section 1001(b) provides that the "amount realized" by the transferor of property is the sum of the money received and the fair market value of any "property" received. If the transferor receives services rather than property, however, the courts have included their fair market value in the "amount realized," and the value of the services seems ordinarily to be ascertained in an arm's-length transaction by assuming that they had the same value as the transferred property. Riley v. Commissioner, 37 T.C. 932 (1962); International Freighting Corp. v. Commissioner, 135 F.2d 310 (2d Cir. 1943).

5. *Expenses of sale as reducing the "amount realized."* Commissions and other selling expenses, unless incurred in the ordinary course of the taxpayer's business, are not deductible under §162 but are instead applied to reduce the "amount realized" in computing his gain or loss. Regs. §1.263(a)-2(e); Spreckels v. Helvering, 315 U.S. 626 (1942); see also Ward v. Commissioner, 224 F.2d 547 (9th Cir. 1955) (selling expenses not deductible under §212); Teschner, Expenses of Sale: Law-Making by the Commissioner, 35 Taxes 574 (1957).

* Under the pre-1934 law, described in the *Egtvedt* case, supra page 150. — ED.

COMMISSIONER v. KANN'S ESTATE

174 F.2d 357 (3d Cir. 1949)

Before BIGGS, Chief Judge, and MCLAUGHLIN and O'CONNELL, Circuit Judges.

BIGGS, Chief Judge.

Mrs. Bertha F. Kann, the decedent, sold certain securities to her children in return for their unsecured promises to pay her life annuities. The question presented for our determination is: Did the Tax Court err in holding that the decedent realized no taxable gain under [§1001(a)], and the applicable regulation [Regs. §1.1001-1(a)] on the ground that annuity contracts undertaken by individual obligors do not have an ascertainable fair market value as a matter of law? . . .

As the Tax Court pointed out it is not necessary to decide whether the entire capital is to be recouped before any amount becomes taxable, Lloyd v. Commissioner, 33 B.T.A. 903; Deering v. Commissioner, 40 B.T.A. 984, or whether a 3% annual return on an investment computed at insurance company rates, Raymond v. Commissioner, 40 B.T.A. 244, affirmed 7 Cir., 114 F.2d 140, certiorari denied 311 U.S. 710, is to be charged as ordinary income under [§22(b)(2) of the 1939 Code] * until the capital expended has been recovered. See Gillespie v. Commissioner, 43 B.T.A. 399, reversed on other grounds, 9 Cir., 128 F.2d 140. The question at bar turns on the meaning to be ascribed to the phrase "fair market value" in [§1001(b)] and the regulation.

The petitioner would have us change what we believe to be a salutary rule of law established by the Board of Tax Appeals in the *Lloyd* case, supra, that where both the annuitant's life span and the obligor's ability to pay are uncertain no fair market value should be ascribed to the contract or obligation. That rule was again enunciated in the *Deering* case, supra, and was viewed with approval in Hommel v. Commissioner, 7 T.C. 992. To elaborate a little, the Tax Court has held in the instant case, as in the past, that where obligors are individuals, whether rich or poor, their obligations to pay in the future do not possess such standing as to come within the purview of the statute, that such obligations possess no value by way of ordinary business. It should be noted that this court took a similar view in Evans v. Rothensies, 3 Cir., 114 F.2d 958, and in Cassatt v. Commissioner, 3 Cir., 137 F.2d 745, wherein, it will be observed, the Commissioner took a position diametrically opposed to that which he seeks to maintain in the case at bar. See also Burnet v. Logan, 283 U.S. 404. Like the Tax Court we think that there is little to be gained by giving up the principle, now well established, that an agreement by an individual to pay a life annuity to another has no "fair market value" for purpose of computing capital gain. In conclusion we state parenthetically that there is little in the record which can support the Commissioner's view that the transactions between Mrs. Kann and her children were ordinary arm's length business transactions. See the *Raymond* case, supra.

The decision of the Tax Court will be affirmed.

O'CONNELL, Circuit Judge (dissenting).

I agree with my brethren that the record before us offers little to support the assertion that decedent engaged in "ordinary arm's length business transactions" when she transferred to her children and their respective spouses the 1,120 shares of stock in return for their unsecured promises to pay her $24,672 per annum. The considerable doubt I have concerning the purported nature of the transac-

* Described in the *Egtvedt* case, supra page 150. — ED.

tions dictates to me the appropriate action to be taken by this court on the tax liability of decedent on those shares of stock.

Decedent was 77½ years of age at the time. Each of her eight children received an identical number of shares of the stock, and each made an unsecured promise to pay her $3,084 per annum. The stock was in a company over which her family had the controlling interest. The executed instruments themselves disclose that retention of family control over the company was an integral element in the transactions. That the value of the shares which she transferred was greater than that necessary to purchase the so-called annuity of $24,672 per annum is demonstrated by the fact that, the same year, she paid a gift tax on what was computed to be the $22,733.89 difference in value between the 1,120 shares of stock and what (according to the American Annuitance Mortality Table) was the total consideration necessary to derive annual installments of $24,672. There is still another indication of how decedent viewed the transactions: despite the provisions of Section 22(b)(2) of the [1939] Internal Revenue Code, calling for inclusion each year of 3% of the aggregate premiums paid for an annuity, decedent made no such inclusions in her tax returns after these transactions were consummated.*

Perhaps an explanation, credible and consistent with an annuity motive, could be offered to show why the same arrangement was made with all eight children, and why no security was required of them; but the combination of all the circumstances outlined above, particularly the payment of a gift tax on what was reputed to be a "sale," seems to me to lead to no conclusion other than that an aged woman made what she believed to be an inter vivos disposition, substitutional of a testamentary one, of that part of her estate represented by the shares of stock. The facts are to me consonant only with the inference that, for federal tax purposes, what decedent really did was to create eight trusts, in each of which she made herself life beneficiary to the extent of $3,084 per annum.

That decedent and her children chose to designate the agreements as private annuity contracts can and should be no obstacle to an inquiry into the real nature of the transactions here involved. Indeed, decedent herself recognized the apparent absence of a bona fide sale when she accepted the Commissioner's valuation and paid the gift tax.

Consequently, as I analyze this case, neither [the annuity provision nor §1002 (a)] is properly applicable, there being no sale or capital gain involved. In practical effect, decedent seems to me to have done no more than pass legal title to 1,120 shares, in return for a reserved life estate as to $24,672 per annum of the income therefrom, and a power to invade the corpus, if necessary, to supplement the income if less than $24,672 per annum. On principles not unlike those enunciated in Commissioner v. Tower, 1946, 327 U.S. 280, and Lusthaus v. Commissioner, 1946, 327 U.S. 293, the Commissioner and the Tax Court should have pierced the window-dressing and determined whether the income from the 1120 shares was taxable to decedent under the provisions of [§61(a)], as long as she remained alive, the shares being part of her estate at her death. . . .

NOTE

1. *An annuity as the "amount realized."* Is the holding in *Kann's Estate* equally applicable to an arm's-length transaction? If the transferred property had been pledged to insure payment of the annuity, and the amount to be paid by the transferee had been calculated on the basis of the transferor's life span as estimated by reference to mortality

* Amended returns, reporting 3 per cent of the amount received, were filed by the decedent's executors. — ED.

tables, would it have been proper to ascribe a "fair market value" to the transferee's agreement?

If the transferee is an organization (e.g., a trust or foundation) rather than an individual, the Internal Revenue Service has ruled that the transaction is a taxable event even though the transferee is not a commercial insurance company, the value of the annuity being determined by reference to the cost of comparable commercial annuities. Rev. Rul. 62-136, 1962-2 C.B. 12. See also Rev. Rul. 60-370, 1960-2 C.B. 203, involving a transfer of appreciated securities to a tax-exempt educational institution under an agreement requiring the securities to be sold and the proceeds invested in tax-exempt bonds, the interest to be paid to the transferor for life (the so-called "Pomona Plan"); the ruling states that the sale is to be imputed to the transferor (so that he is taxable on the gain), even though the value of the life interest is less than the value of the securities or their basis in the transferor's hands.

With the dissenting judge's suggestion in *Kann's Estate* that the annuity payments were not an "amount realized" because they were reserved, rather than received, by the transferor, see Kruesel v. United States, — F. Supp. — (D. Minn. 1963), involving a sale of farm property for $225,000, subject to the vendors' right to occupy the property rent-free for life. The court held that the life estate was reserved by the vendors, and hence was not part of the "amount realized." If so, was the basis of the property sold the full adjusted basis of the fee, or that amount less the basis of the reserved rights?

2. *Tax consequences to the transferee.* If the annuity arrangement, though between private persons, is an arm's-length transaction, and the property transferred is depreciable, the transferee's basis for depreciation is the value of the prospective payments, based on the annuitant's life expectancy, increased if and when payments in excess of this value are made. See Rev. Rul. 55-119, 1955-1 C.B. 352, for this and other aspects of the transferee's basis.

3. *References.* Andro, Non-Commercial Annuities — Income Tax Consequences to the Transferor Who Exchanges Property in Return for an Annuity, 9 Tax L. Rev. 85 (1953); Lowry, The Income Tax and Purchases of Property by Non-Commercial Annuity Agreements, id. 191 (1954).

PARKER v. DELANEY

186 F.2d 455 (1st Cir. 1950)

Before MAGRUDER, Chief Judge, and WOODBURY and FAHY, Circuit Judges.

FAHY, Circuit Judge.

Appellant paid a federal income tax for 1945 on the basis of a long term capital gain which he then thought he had realized from the disposition of certain apartment houses during that year. Thereafter, becoming of a different view, he applied for refund of the amount paid. Six months having elapsed without action on his application he brought suit in the District Court against the Collector of Internal Revenue, as authorized by United States Code Annotated, Title 28, §1340. He appeals from judgment rendered for the Collector.

The essential facts were stipulated. In 1933, 1934 and 1936, taxpayer made arrangements with two banks to take over and manage four apartment house properties held by the banks after foreclosure proceedings. The same general factual pattern of transactions applies to each property. It was deeded by the bank to a straw man who acted for taxpayer. The straw gave the bank a note in a stated amount secured by a first mortgage on the property. He gave taxpayer second mortgages on each of the properties, and powers of attorney to operate the same. He also gave the taxpayer a deed to each of the properties, but these deeds were not recorded.

Appellant for tax purposes reported each year all income and took all deductions to which he would be entitled as owner, including deductions for depreciation. In 1945 the mortgages were in default and by agreement the banks took back the properties, the straw giving quitclaim deeds. The second mortgages

upon such properties were discharged of record. In his federal income tax return for 1945 appellant stated the sale prices to the banks to be the face amounts of the mortgages at the time of the conveyances to the banks. He reported the excess of these amounts over the amounts of the mortgages when he acquired the properties, less depreciation, as a long term capital gain.[1]

Appellant's position essentially is that he realized nothing when the properties were reconveyed to the banks in 1945 and so there was legally nothing to tax as a gain under the applicable provisions [§1001(a) and (b)] of the Internal Revenue Code. . . .

That there was a disposition of the properties by appellant in 1945 seems clear. The quitclaim deeds to the banks, though executed by the straw man, covered properties to which title had been conveyed to appellant though the deeds to him were unrecorded. The straw acted for him in transferring the properties to the banks. Appellant had regularly reported for tax purposes all income and had taken all deductions, including those for depreciation, to which he would be entitled as owner. The serious question is not whether there was a disposition within the meaning of [§1001(a)], as to which we are clear, but . . . whether taxpayer received from his disposition of the apartment houses money or other property of a value in excess of the amount of their adjusted basis, that is, in excess of the cost of the properties less depreciation.

In applying the foregoing formula to the facts we may conveniently consider first the question of the cost of the properties to appellant. During the years of his operation of them he took deductions for depreciation on a cost basis equal to the amount of the first mortgage liens. In this court he expressly disclaims any contention that their value for depreciation purposes was less than those liens. These mortgages represented the prices paid, or the consideration, for the properties. The properties became subject to these liens and appellant considered them as the cost in deducting depreciation. Nothing appears to the contrary and we must, as did the court below, accept these figures of cost used by appellant. Indeed we do not understand him to dispute this treatment of the cost question.

The depreciation deductions, taken on the basis discussed above, amounted to $45,000. We come to the time of disposition, therefore, with that amount having been set aside from gross income and put in capital account for replacement purposes, the justification for permitting depreciation deductions in computing taxable income. . . . The adjusted basis in 1945 accordingly was $273,000 less $45,000, or $228,000. The question is whether more than this was realized from disposition of the properties in that year. . . . It is here the real controversy arises. Appellant contends that he realized nothing or in any event nothing in excess of the adjusted basis of $228,000, though the amount of the mortgages then was $31,000 in excess of said adjusted basis. See footnote 1, supra.

The burden of deciding whether or not the last named figure was gain we think has been assumed by Crane v. Commissioner, 331 U.S. 1. In that case there was a sale of improved real estate to a third party subject to the amount of the mortgage, plus $3,000 boot paid to the seller. The latter, like appellant here, was not personally liable on the mortgage. In the instant case the disposition was to the mortgagees instead of to a third party purchaser and no boot was paid.

In the *Crane* case the taxpayer contended that all she received was the boot, and that its amount, less expenses of the sale, was the amount of gain realized.

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1 The first mortgage liens totaled $273,000 at the time of appellant's acquisition of the properties. During the period of his operation he paid on these mortgages a total of $14,000. He charged and deducted depreciation in the amount of $45,000. When, therefore, the apartments were conveyed to the banks in 1945, the gain was $31,000. The disputed tax resulted. . . .

[In the interest of simplicity, the amounts have been rounded off, here and in the text. — ED.]

But the Supreme Court held that the taxpayer received benefit in the amount of the mortgage as well as the boot. We see no logical or practical distinction which takes the present case out of the rationale of that decision. If the amount of the unassumed mortgage in the *Crane* case was properly included in the amount realized on the sale, the amounts of the unassumed mortgages should be held to have been realized on the disposition in this case. In both, such amounts had been considered in determining the unadjusted basis. Since in the *Crane* case taxpayer obtained the property by devise, the basis was the fair market value at the time of acquisition. [§1014.] In the case at bar the basis was cost. [§1012.] Depreciation had been computed and deducted on such amounts; and their relationship under [§1016(a)(2)] to the question of gain realized under [§1001(a)] requires that account be taken of such value or cost in determining the realization on disposition. Furthermore, the property in the hands of appellant was relieved at the time of disposition of the mortgage liens and obligations. So far as appellant was concerned as owner these were paid even though he was not personally liable for them. The matter was so treated in the *Crane* case, 331 U.S. at 13. The added factor there, not present here, that boot was paid over and above the mortgage, is not material so long as the value of the properties was not less than the liens. Boot served to show this in the *Crane* case, but the payment of boot is of course not the only means of showing whether or not value is equal to or more than the liens on the property disposed of.

This brings us to appellant's contention that in fact the value was less and the *Crane* doctrine accordingly does not apply. He points out that the Supreme Court, in such a situation, reserved decision: "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case." Footnote 37, 331 U.S. at 14.

This statement is predicated upon a situation where the value of the property when disposed of is less than the mortgage. There is no evidence to that effect in this case. The District Court treated the value as equal to the mortgages and we have no basis for doing otherwise. The critical point is that the value equaled the mortgages, not that it exceeded them, and on this factual matter we must on the record support the conclusion of the District Court.

[Discussion of whether the taxpayer's gain was capital gain or ordinary income omitted.]

The judgment of the District Court is affirmed.

MAGRUDER, Chief Judge (concurring).

I concur. The logic of the court's opinion is inescapable, with Crane v. Commissioner, 331 U.S. 1, as the starting point.

As an original matter, I would have had some difficulty in understanding how the taxpayer in the *Crane* case realized more than $3,000 from her sale of the mortgaged property there involved, in view of the definition of "amount realized" in [§1001(b)]. By the same token in the case at bar, under the more natural and obvious reading of [§1001(b)], it would seem that the amount realized by the taxpayer herein was zero, when he caused his straw man to quitclaim to the banks, for no cash consideration, properties then subject to mortgages up to their full value, the taxpayer not being liable on the mortgage debt. To reach the conclusion that the taxpayer thereby "realized" the amount of the outstanding mortgage debt would seem to require a somewhat esoteric interpretation of the statutory language. Also, I do not clearly understand why the Treasury allowed the taxpayer deductions for depreciation, under [§167(g)], in the total amount of $45,000,

taking the taxpayer's original "cost" basis as the amount of the mortgages, though he made no cash investment in the properties upon acquisition, nor did he obligate himself on the mortgage debt. But that matter need not concern us here, because depreciation in the amount of $45,000 was in fact "allowed"; and under [§1016(a)(2)] the adjusted basis for determining gain or loss from the sale or other disposition of the property takes account of depreciation "to the extent allowed (but not less than the amount allowable)" under the income tax laws.

Perhaps the net result reached by the court here might be arrived at by another mode of computation with less strain upon the statutory language. Thus, the adjusted basis for determining gain or loss under [§1016(a)(2)] might be computed as follows: Original cost, zero, plus $14,000, the total amount which taxpayer paid in reduction of the mortgage debt while he held the properties, minus $45,000, the amount of depreciation "allowed," which comes out to an adjusted basis of minus $31,000. Now, apply that adjusted basis of minus $31,000 to the computation of gain or loss under the formula in [§1001(b)]: The "amount realized" upon taxpayer's disposition of the properties, zero (as suggested above), minus the adjusted basis as computed under [§1016(a) (2)], or in other words, minus $31,000, subtracted from zero, comes out to a plus figure of $31,000, representing the amount of the taxpayer's gain, upon which the tax would be computed.

NOTE

1. *Unassumed mortgage as "amount realized."* In what sense was "the property in the hands of appellant [taxpayer] . . . relieved at the time of disposition of the mortgage liens and obligations"? Did the taxpayer derive any economic benefit from this discharge of the first mortgages? Would his benefit (if there was any) have been any the less if the property had been worth less than the unpaid principal when it was turned over to the mortgagee? Does Parker v. Delaney imply that the taxpayer would have realized a gain if the property was not insured and had been destroyed by fire during the period of his ownership?

2. *Negative basis.* Would Judge Magruder's use of a negative basis as a means of computing a gain of $31,000 have led to the same result if the properties had been worth less than the mortgage debt when they were reconveyed by the taxpayer to the banks in 1945? On the still exotic concept of negative basis, see Cooper, Negative Basis, 75 Harv. L. Rev. 1352 (1962).

Section E. Non-Recognition Transactions

Section 1031, providing for the non-recognition of gain or loss on the exchange of "like kind" property, is identical with §112(b)(1) of the 1939 Code.

Section 1033, providing for the non-recognition of gain on certain involuntary conversions of property, is similar to §112(f) of the 1939 Code.

Section 1034, providing for the non-recognition of gain on a sale or exchange of the taxpayer's personal residence if he acquired another residence within a specified period, is similar to §112(n) of the 1939 Code.

JORDAN MARSH CO. v. COMMISSIONER

269 F.2d 453 (1959) *

Before Hincks, Lumbard and Moore, Circuit Judges.

* Non-acquiescence, Rev. Rul. 60-43, 1960-1 C.B. 687.

HINCKS, Circuit Judge.

This is a petition to review an order of the Tax Court, which upheld the Commissioner's deficiency assessment of $2,101,823.39 in income and excess profits tax against the petitioner, Jordan Marsh Company. There is no dispute as to the facts, which were stipulated before the Tax Court and which are set forth in substance below.

The transactions giving rise to the dispute were conveyances by the petitioner in 1944 of the fee of two parcels of property in the city of Boston where the petitioner, then as now, operated a department store. In return for its conveyances the petitioner received $2,300,000 in cash which, concededly, represented the fair market value of the properties. The conveyances were unconditional, without provision of any option to repurchase. At the same time, the petitioner received back from the vendees leases of the same properties for terms of 30 years and 3 days, with options to renew for another 30 years if the petitioner-lessee should erect new buildings thereon. The vendees were in no way connected with the petitioner. The rentals to be paid under the leases concededly were full and normal rentals so that the leasehold interests which devolved upon the petitioner were of no capital value.

In its return for 1944, the petitioner, claiming the transaction was a sale under [§1002], sought to deduct from income the difference [$2,500,000] between the adjusted basis of the property [$4,800,000] and the cash received [$2,300,000]. The Commissioner disallowed the deduction, taking the position that the transaction represented an exchange of property for other property of like kind. Under [§1031(a)] such exchanges are not occasions for the recognition of gain or loss; and even the receipt of cash or other property in the exchange of the properties of like kind is not enough to permit the taxpayer to recognize loss [§1031(c)]. Thus the Commissioner viewed the transaction, in substance, as an exchange of a fee interest for a long term lease, justifying his position by [Regs. §1.1031(a)-1(c)], which provides that leasehold of more than 30 years is the equivalent of a fee interest. . . .

Upon this appeal, we must decide whether the transaction in question here was a sale or an exchange of property for other property of like kind within the meaning of [§1031(a) and (c)]. If we should find that it is an exchange, we would then have to decide whether the Commissioner's regulation, declaring that a leasehold of property of 30 years or more is property "of like kind" to the fee in the same property, is a reasonable gloss to put upon the words of the statute. The judge in the Tax Court felt that Century Electric Co. v. Commissioner, 8 Cir., 192 F.2d 155, certiorari denied 342 U.S. 954, was dispositive of both questions. In the view which we take of the first question, we do not have to pass upon the second question. For we hold that the transaction here was a sale and not an exchange.

The controversy centers around the purposes of Congress in enacting [§1031(a)], dealing with non-taxable exchanges. The section represents an exception to the general rule, stated in [§1002], that upon the sale or exchange of property the entire amount of gain or loss is to be recognized by the taxpayer. The first Congressional attempt to make certain exchanges of this kind non-taxable occurred in Section 202(c), Revenue Act of 1921. Under this section, no gain or loss was recognized from an exchange of property unless the property received in exchange had a "readily realizable market value." In 1924, this section was amended to the form in which it is applicable here. Discussing the old section the House Committee observed:

> The provision is so indefinite that it cannot be applied with accuracy or with consistency. It appears best to provide generally that gain or loss is recognized from all ex-

changes, and then except specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result. [Committee Reports on Rev. Act of 1924, reprinted in 1939-1 C.B. (Part 2) 250.]

Thus the "readily realizable market value" test disappeared from the statute. A later report, reviewing the section, expressed its purpose as follows:

The law has provided for 12 years that gain or loss is recognized on exchanges of property having a fair market value, such as stocks, bonds, and negotiable instruments; on exchanges of property held primarily for sale; or on exchanges of one kind of property for another kind of property; but not on other exchanges of property solely for property of like kind. In other words, profit or loss is recognized in the case of exchanges of notes or securities, which are essentially like money; or in the case of stock in trade; or in case the taxpayer exchanges the property comprising his original investment for a different kind of property; *but if the taxpayer's money is still tied up in the same kind of property* as that in which it was originally invested, he is not allowed to compute and deduct his theoretical loss on the exchange, nor is he charged with a tax upon his theoretical profit. The calculation of the profit or loss is deferred until it is realized in cash, marketable securities, or other property not of the same kind having a fair market value. [House Ways and Means Committee Report, reprinted in 1939-1 C.B. (Part 2) 564 (emphasis supplied).]

These passages lead us to accept as correct the petitioner's position with respect to the purposes of the section. Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort. If such gains were not to be recognized, however, upon the ground that they were theoretical, neither should equally theoretical losses. And as to both gains and losses the taxpayer should not have it within his power to avoid the operation of the section by stipulating for the addition of cash, or boot, to the property received in exchange. These considerations, rather than concern for the difficulty of the administrative task of making the valuations necessary to compute gains and losses, were at the root of the Congressional purpose in enacting [§1031(a) and (c)]. Indeed, if these sections had been intended to obviate the necessity of making difficult valuations, one would have expected them to provide for nonrecognition of gains and losses in all exchanges, whether the property received in exchanges were "of a like kind" or not of a like kind. And if such had been the legislative objective [§1031(b)], providing for the recognition of gain from exchanges not wholly in kind, would never have been enacted.

That such indeed was the legislative objective is supported by Portland Oil Co. v. Commissioner, 1 Cir., 109 F.2d 479. There Judge Magruder, in speaking of a cognate provision [§351(a), providing for the non-recognition of gain or loss on the transfer of property to a corporation controlled by the transferor] said:

It is the purpose of [§351(a)] to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really "cashed in" on the theoretical gain, or closed out a losing venture.

In conformity with this reading of the statute, we think the petitioner here, by its unconditional conveyances to a stranger, had done more than make a change in the *form of ownership:* it was a change as to the *quantum* of ownership whereby, in the words just quoted, it had "closed out a losing venture." By the transaction its capital invested in the real estate involved had been completely liquidated for cash to an amount fully equal to the value of the fee. This, we hold, was a sale — not an exchange within the purview of [§1031].

The Tax Court apparently thought it of controlling importance that the transaction in question involved no change in the petitioner's possession of the premises: it felt that the decision in Century Electric Co. v. Commissioner, supra, controlled the situation here. We think, however, that that case was distinguishable on the facts. For notwithstanding the lengthy findings made with meticulous care by the Tax Court in that case, 15 T.C. 581, there was no finding that the cash received by the taxpayer was the full equivalent of the value of the fee which the taxpayer had conveyed to the vendee-lessor, and no finding that the lease-back called for a rent which was fully equal to the rental value of the premises. Indeed, in its opinion the Court of Appeals pointed to evidence that the fee which the taxpayer had "exchanged" may have had a value substantially in excess of the cash received. And in the *Century Electric* case, the findings showed, 15 T.C. at 585, that the taxpayer-lessee, unlike the taxpayer here, was not required to pay "general state, city and school taxes" because its lessor was an educational institution which under its charter was exempt from such taxes. Thus the leasehold interest in *Century Electric* on this account may well have had a premium value. In the absence of findings as to the values of the properties allegedly "exchanged," necessarily there could be no finding of a loss. And without proof of a loss, of course, the taxpayer could not prevail. Indeed, in the Tax Court six of the judges expressly based their concurrences on that limited ground. . . .

In ordinary usage, an "exchange" means the giving of one piece of property in return for another — not, as the Commissioner urges here, the return of a lesser interest in a property received from another. It seems unlikely that Congress intended that an "exchange" should have the strained meaning for which the Commissioner contends. For the legislative history states expressly an intent to correct the indefiniteness of prior versions of the Act by excepting from the general rule "specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss."

But even if under certain circumstances the return of a part of the property conveyed may constitute an exchange for purposes of [§1031], we think that in this case, in which cash was received for the full value of the property conveyed, the transaction must be classified as a sale. Standard Envelope Manufacturing Co. v. C.I.R., 15 T.C. 41; May Department Stores Co. v. C.I.R., 16 T.C. 547.

Reversed.

NOTE

1. *Exchanges for property of a "like kind."* If the taxpayer had received substantially less (or more) than $2,300,000 in cash, and the business bargain had been equalized by a lower (or higher) annual rent, would the court have found that the transaction was an "exchange" within the meaning of §1031 (a)? If so, would the exchange have been for property of a "like kind"? See Regs. §1.1031(a)-1(c) (leasehold for 30 years exchanged for fee; held, qualified); Century Electric Co. v. Commissioner, cited supra in *Jordan Marsh* (exchange of fee for 95-year leasehold plus cash qualifies); Standard Envelope Manufacturing Co. v. Commissioner, 15 T.C. 41 (1950) (fee for 25-year leasehold; held, not qualified).

Would the result in *Jordan Marsh* have been the same if the taxpayer had received less cash on the exchange but had been allowed to occupy the premises rent-free for an extended term?

What is the impact of the *Jordan Marsh Co.* case on a "trade-in" of used equipment for new equipment of a like kind? Does the applicability of §1031(a) depend on whether the taxpayer receives a check from the dealer and pays cash for the new equipment, or receives a credit against the price and pays only the difference?

Section 1031(a) applies to exchanges of property held "for productive use in trade or business" or "for investment" (excluding property held for sale, corporate securities, etc.);

and it has been held that the "like kind" test is satisfied even though productive property is exchanged for investment property, or vice versa. Regs. §1.1031(a)-1(a); Braley v. Commissioner, 14 B.T.A. 1153 (1929) (investment real estate exchanged for working ranch).

2. *Three-party transactions.* If Jones wants to trade his appreciated real estate for property of a like kind owned by Smith, but Smith is interested in a sale rather than an exchange, will §1031 be satisfied (as to Jones) if he transfers the property to Adams on the strength of Adams' promise to acquire the Smith property and transfer it to Jones as soon as he is able to sell the Jones property? Such three-party substitutes for two-party exchanges may take a variety of forms; on the whole, the courts have found them to qualify under §1031. See Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); Baird Publishing Co. v. Commissioner, 39 T.C. 608 (1962).

What if the agreement provides (a) that the taxpayer will transfer his property to Adams; (b) that within one year Adams will either pay $1,000,000 in cash or, at the taxpayer's option, acquire and transfer to the taxpayer such property as the taxpayer may designate, with any difference between the cost of the designated property and $1,000,000 being paid by or to the taxpayer, as the case may be; and (c) that Adams will lease the original property to the taxpayer until the option is exercised or expires?

3. *Effect of "boot."* If property with an adjusted basis of $100,000 is transferred for property of a like kind with a fair market value of $125,000 plus cash or other non-qualifying property of $25,000, the taxpayer "realizes" gain of $50,000. If §1031(a) and (b) are applicable, however, the realized gain is "recognized" only to the extent of $25,000 — the amount of cash or non-qualifying property received. (The cash or non-qualified property is usually called "boot," because in the exchange the taxpayer received qualified property plus cash or other property "to boot.") What would be the recognized gain if the property had been worth $150,000 and had been exchanged for qualified property worth $75,000 plus $75,000 in cash?

Although the receipt of "boot" requires the taxpayer's realized gain to be recognized pro tanto, it will not permit a realized loss to be recognized, by virtue of §1031(c) (on which the government relied in the *Jordan Marsh Co.* case). Why does "boot" operate differently for a realized loss than for a realized gain?

4. *Carryover of basis under §1031(d).* If property is exchanged solely for property of a like kind in an exchange that qualifies under §1031(a), the taxpayer's adjusted basis for the transferred property becomes his basis for the acquired property under §1031(d). Such a provision for a "carryover" of basis — referred to as a "substituted basis" by §1016(b) — is customary in the non-recognition provisions, and explains why they are sometimes referred to as "postponement" provisions. On the theory that the taxpayer did not "close out" his investment when he disposed of the old property, computation of his gain or loss is postponed until he disposes of the new property. (If the new property is depreciable, the taxpayer's deductions under §167(a) will be tied to his basis for the old property.) There may be a series of non-recognition exchanges, of course, in which event the day of reckoning may be postponed repeatedly. Finally, if the taxpayer holds the new property until his death, the postponed gain or loss goes totally unrecognized by virtue of §1014 (basis to heirs of inherited property is fair market value at death). This result is not uncommon in the case of investment real estate which was exchanged under §1031(a), and it is also a frequent occurrence in the case of corporate securities, since exchanges by merger, consolidation, etc. are usually non-recognition transactions.

Note how the basis of the new property is computed if the taxpayer acquires it for old property plus cash, or if he receives "boot" on the exchange. If the *Jordan Marsh Co.* exchange had been held to qualify under §1031(a), how would the taxpayer have taken its adjusted basis for the old property (about $4.8 million) into account?

5. *References.* Molloy, Tax-free Exchanges of Property of Like Kind Under Section 112(b)(1), 37 Va. L. Rev. 555 (1951); for sale-and-leaseback transactions, see Cary, Corporate Financing Through the Sale and Lease-Back of Property: Business, Tax, and Policy Considerations, 62 Harv. L. Rev. 1 (1948), and Current Tax Problems in Sale, or Gift, and Lease-Back Transactions, 9 N.Y.U. Inst. on Fed. Taxation 959 (1951).

LIANT RECORD, INC. v. COMMISSIONER

303 F.2d 326 (2d Cir. 1962)

Before LUMBARD, Chief Judge, and SWAN and WATERMAN, Circuit Judges.

LUMBARD, Chief Judge.

The sole question presented is whether the proceeds from the condemnation of an office building were reinvested in property which was "similar or related in service or use" within the meaning of §1033 of the Internal Revenue Code of 1954 when the taxpayers purchased three apartment buildings. The Tax Court held that they were not, since the tenants of the office building used the property for a different purpose than the tenants of the apartment buildings. We reverse and remand.

The taxpayers and Norman Einstein owned a 25-story, steel-frame office building located at 1819 Broadway, Manhattan, New York. The building, which had been erected about 1913 was, on November 17, 1953, rented to 82 commercial tenants, including accountants, attorneys, real estate firms, a doctor, a dentist, and a bank, all of whom used it exclusively to conduct business. On November 17, 1953 the City of New York instituted condemnation proceedings against the taxpayers' office building and acquired title on the same date. Each of the taxpayers received payments in settlement for the condemned property during 1954 and 1955 which substantially exceeded their respective tax bases in the property.

Between July 12, 1955 and November 1, 1956 the taxpayers acquired three pieces of real estate each containing an apartment building. Each taxpayer's contribution to the total purchase prices of the three parcels exceeded his share of the proceeds from the condemnation. The 9-story building located at 55 West 11th Street, New York City, contained 77 apartments used for residential purposes and commercial tenants. The 6-story brick building at 400 East 80th Street, New York City, contained 47 residential apartments and 4 stores. The 11-story, steel-frame building located at 35 East 84th Street, New York City, contained 40 residential apartments and 6 commercial tenants. The taxpayers held the properties for rental income and did not occupy any of the properties.

The taxpayers, contending that their gain on the involuntary conversion was nontaxable under §1033 of the Internal Revenue Code of 1954, did not report any income from the disposition of the condemned office building. The Commissioner, on the other hand, took the view that the three apartment buildings were not "similar or related in service or use" to the condemned office building, and that therefore the taxpayers should have reported an aggregate capital gain on their 1955 income tax returns of $427,012.61. Consequently, the Commissioner asserted an aggregate deficiency of $107,716.51 against the taxpayers. The Tax Court upheld the deficiency on the ground that the actual physical end use of the original property by the lessees as offices, differed from the end use of the replacement properties by the lessees as apartments. 36 T.C. 224 (1961). The taxpayers appeal.

When a taxpayer's property is involuntarily converted into cash which the taxpayer immediately expends in replacing the converted property, Congress thought it fair to postpone any tax on the gain. Winter Realty & Constr. Co. v. Commissioner, 149 F.2d 567 (2 Cir.), cert. denied, 326 U.S. 754 (1945). However, the fortuity of an involuntary conversion should not afford the taxpayer an opportunity to alter the nature of his investment tax-free. Therefore, under §1033 and its predecessors, tax postponement turns on whether the replacement property is "similar or related in service or use" to the converted property.

Most of the early cases interpreting this phrase involved owners of property

who themselves used the property in their businesses. In these cases the Tax Court adopted a so-called "functional test" to determine whether the replacement property was similar or related in service or use to the converted property, i.e., the Tax Court compared the actual physical uses of both properties. In those cases where an owner of property, instead of being a user, held the property for rental to others and replaced it with rental property, the Commissioner, the Third Circuit and the Tax Court literally applied this "functional test" by holding that the tenants' actual physical use of the converted and replacement properties must be similar or related. Some courts, however, refusing to apply the "functional test" so strictly, have held that if the owner of rental property replaces it with rental property of "the same general class," he has maintained sufficient continuity of interest to deserve tax postponement.

Since in enacting this section Congress intended the taxpayer-owner to maintain continuity of interest and not to alter the nature of his investment tax-free, it is the service or use which the properties have to the taxpayer-owner that is relevant. Thus when the taxpayer-owner himself uses the converted property, the Tax Court is correct in comparing the actual physical service or use which the end user makes of the converted and the replacement properties. However, if the taxpayer-owner is an investor rather than a user, it is not the lessees' actual physical use but the nature of the lessor's relation to the land which must be examined. For example, if the taxpayer-owner himself operated a retail grocery business on the original land and operated an automobile sales room on the replacement land, it would be obvious that by changing his own end use he had so changed the nature of his relationship to the property as to be outside the nonrecognition provision. However, where the taxpayer is a lessor, renting the original land and building for a retail grocery store and renting the replacement land and building for an automobile sales room, the nature of the taxpayer-owner's service or use of the property remains similar although that of the end user changes. There is, therefore, a single test to be applied to both users and investors, i.e., a comparison of the services or uses of the original and replacement properties *to the taxpayer-owner*. In applying such a test to a lessor, a court must compare, inter alia, the extent and type of the lessor's management activity, the amount and kind of services rendered by him to the tenants, and the nature of his business risks connected with the properties.

Section 1031 of the 1954 Code has many similarities to §1033, the provision here in question. While §1033 postpones the taxation of gain on the involuntary conversion of any property into money which is then reinvested in property which is "similar or related in service or use," §1031 postpones the taxation of gain when a narrower category, "property held for productive use in trade or business or for investment," is voluntarily exchanged directly for other property "of a like kind." "Like kind" has been interpreted as being much broader than "similar or related in service or use." In 1958 Congress, disapproving of the narrow manner in which the §1033 standard had been applied, S. Rept. No. 1983, 85th Cong., 2d Sess. [reprinted in 1958-3 C.B. 922, 993], amended §1033 and made the "like kind" standard applicable to the condemnation of real estate "held for productive use in trade or business or for investment." [See §1033(g).] The government argues that because this amendment is specifically made prospective only, Congress meant to tax the gain on condemnations of real estate held for investment in transactions which ante-dated the amendment such as in the present case. However, the mere fact office buildings and apartment buildings are clearly of "like kind" does not mean that they are not also "similar or related in service or use."

Since the Tax Court examined only the actual physical end use of the properties in this case rather than comparing the properties' service or use to the

taxpayer-lessor, we reverse and remand for further consideration in the light of this opinion.

NOTE

1. *The "taxpayer's use" test.* On remand, the Tax Court found that the differences "in the petitioners' management activity, the services rendered by them to tenants, and their business risks with respect to the apartment buildings as compared with the office building" were not substantial. ¶63,053 P-H Memo T.C. Compare Clifton Investment Co. v. Commissioner, 312 F.2d 719 (6th Cir. 1963), accepting the "taxpayer's use" test as promulgated in the *Liant Record* case, and holding that replacement of a commercial office building held for rental with a hotel to be operated by the taxpayer did not qualify under §1033. What if the hotel had been leased on a long-term lease to a hotel operator? Would the answer depend upon whether (a) the lessee was owned by or affiliated with the taxpayer, or (b) the taxpayer was entitled to receive a percentage of the operating profits? For an extended review of the cases in this area, see Loco Realty Co. v. Commissioner, 306 F.2d 207 (8th Cir. 1962).

Many of the litigated rental property cases under §1033 would have qualified under §1033(g), described in the *Liant Record* case, had it been in effect for the taxable years in question. Note, however, that §1033(g) is by no means co-extensive with §1033, so that the "similar or related in service or use" requirement continues in effect for a variety of transactions that otherwise meet the requirements of §1033.

2. *Meaning of "involuntary conversion."* It has been held that the taxpayer's unwillingness to dispose of property does not necessarily mean that it has been "compulsorily or involuntarily converted"; the involuntary transaction must be caused by one of the events specified in §1033(a). See Behr-Manning Corp. v. United States, 196 F. Supp. 129 (D. Mass. 1961) (sale under anti-trust decree does not qualify). On the other hand, a sale under threat of condemnation qualifies even if the purchaser is a private person rather than the condemning authority. Creative Solutions, Inc. v. United States, 320 F.2d 809 (5th Cir. 1963); see also Rev. Rul. 63-221, 1963-2 C.B. — ("threat" or "imminence" of condemnation exists when public agency states or confirms its decision to acquire the property and taxpayer has reasonable grounds to believe that condemnation will be instituted if he does not sell voluntarily).

By virtue of §1033(d), (e), and (f), the term "involuntary conversion" is made applicable to property sold in order to comply with federal reclamation laws relating to irrigation projects, to livestock sold or destroyed because of disease, and to certain livestock sold because of drought.

3. *Sale and repurchase of taxpayer's principal residence.* By virtue of §1034, gain on a sale of the taxpayer's principal residence is not recognized if the taxpayer purchases and uses other property as his principal residence within a year (before or after) the sale of the old residence, provided the new residence costs at least as much as the "adjusted sales price" of the old residence. If the new residence is less costly, so that the taxpayer in effect receives "boot" in the transaction, his realized gain is recognized pro tanto. Any gain that goes unrecognized under §1034 is deducted from the cost of the new residence in computing its basis. The provision contains a number of refinements, including an extension of the time limit to eighteen months if the new residence is constructed by the taxpayer rather than purchased, a longer extension of time if the taxpayer is a member of the armed forces, a special definition of the "adjusted sales price" of the old residence to allow the taxpayer the benefit of "fixing-up" expenses, and a provision permitting cooperative apartments to qualify.

Section 1034 entered the Code in 1951, its purpose being explained by the House Committee on Ways and Means as follows:

> [The proposed provision] amends the present provisions relating to a gain on the sale of a taxpayer's principal residence so as to eliminate a hardship under existing law which provides that when a personal residence is sold at a gain the difference between its adjusted basis and the sale price is taxed as a capital gain. The hardship is accentuated when the transactions are necessitated by such facts as an increase in

the size of the family or a change in the place of the taxpayer's employment. In these situations the transaction partakes of the nature of an involuntary conversion. Cases of this type are particularly numerous in periods of rapid change such as mobilization or reconversion. For this reason the need for remedial action at the present time is urgent. . . .

This special treatment is not limited to the "involuntary conversion" type of case, where the taxpayer is forced to sell his home because the place of his employment is changed. While the need for relief is especially clear in such cases, an attempt to confine the provision to them would increase the task of administration very much. [H.R. Rept. No. 586, reprinted in 1951-2 C.B. 357, 377.]

Section 1034 permits non-recognition of gain as often as the taxpayer qualifies, so that upward financial mobility may permit a series of non-taxable sales as he moves from residence to residence, with a final forgiveness of the unrecognized gain by virtue of the heir's stepped-up basis on the taxpayer's death. Moreover, by virtue of the enactment of §121 in 1964, the gain realized by a person aged 65 or more on selling his residence will not be recognized (if the adjusted sales price is $20,000 or less) or will be recognized only in part (sales price over $20,000), subject to certain limitations.

For some of the problems in applying §1034 — what is a "principal residence"? when is it "used"? — see United States v. Sheahan, 323 F.2d 383 (5th Cir. 1963), and cases there cited.

4. *Other non-recognition provisions.* The Code contains a number of other non-recognition provisions, most notably those applicable to exchanges of stock and securities in corporate reorganizations. These provisions (infra p. 722) rest to some extent on the assumption that the exchange does not substantially alter the taxpayer's economic position; this assumption — which is often contrary to fact — is sometimes buttressed by the theory that the transaction is involuntary, a theory that in turn may, or may not, correspond to the facts. Often, however, these non-recognition provisions are defended on a broader ground: that they facilitate desirable corporate readjustments that would be seriously hampered if the taxpayer's gain were recognized on the exchange.

5. *Variations among the non-recognition provisions.* There are many variations among the non-recognition provisions: §1031 applies to both gain and loss and is mandatory, while §1033 applies only to gain and is elective with the taxpayer; §1031 applies only to exchanges, while §1033 applies to sales and some other transactions in which the taxpayer receives cash, provided he reinvests the proceeds within a specified period of time; §1031 does not apply to the acquisition of stock, while §1033 permits the taxpayer to acquire stock in a corporation owning the replacement property; and there are other differences between §1031 and §1033 as well as between these provisions and such other non-recognition provisions as §1034. Focusing only on §1031, §1033, and §1034, why do they differ (a) in requiring gain and loss, or only gain, to go unrecognized; (b) in being mandatory or elective; (c) as to the time permitted for replacing the old property; and (d) in the degree of similarity required between the old property and its replacement?

6. *Reference.* Miller, Land Condemnation — Federal Income Tax Consequences, 38 Neb. L. Rev. 507 (1959).

CHAPTER 6

Capital Gains and Losses

Section A. Introductory

SELTZER, THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES

*3-5, 8-12 (National Bureau of Economic Research, 1951)**

Capital gains vs. ordinary profits

In both law and common speech, capital gains are generally regarded as the profits realized from increases in the market value of any assets that are not a part of the owner's stock-in-trade or that he does not regularly offer for sale; and capital losses, as the losses realized from declines in the market value of such assets. *Ordinary* profits and losses, in contrast, are realized on the sale of goods and services that *are* a part of the seller's stock-in-trade or that he regularly offers for sale. The profit earned by a manufacturing company through the operation of its plants and machinery may be contrasted with the gain it would make if it sold some of its investment securities for more than they had cost it. The former is an ordinary business profit,† the latter a capital gain.

Ordinary profits are commonly the result of buying goods in one market and selling them in another, that is, in a different form, in different quantities, at a different season, or in a different place. The manufacturer earns ordinary profits by converting raw materials and semifinished goods into new forms, which he sells to other manufacturers, wholesalers, retailers, or consumers. The wholesaler buys in large quantities from the manufacturer and relieves the latter of the task of finding and supplying scores of retail outlets. The retailer earns ordinary income by buying his wares from wholesalers, jobbers, and manufacturers, and selling them to his customers in much smaller unit-quantities, together with packaging, and perhaps delivery and credit services. Capital gains or losses, on the other hand, are most commonly the result of changes in prices in the same market. They are realized most characteristically when one investor or speculator sells his holdings to another. The profit made by a real estate company that buys raw acreage, subdivides it into streets and building lots, and sells plots, is regarded as an ordinary business profit; but the gain made by the farmer or long term speculator who sells the acreage to the real estate company, or by the factory worker who purchases a single lot and subsequently resells it, is regarded as a capital gain. . . .

Distinction between capital gains and ordinary income often blurred

While the broad distinction we have made between capital gains and ordinary profits is useful in a general way, it cannot be pressed far for purposes of either

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† As will be seen (infra p. 552), the manufacturer's plant and machinery are not "capital assets" as that term is defined by §1221, but gain on a sale of such property is ordinarily taxed as capital gain as a result of special legislation (§1231) that was enacted during World War II. — Ed.

economic analysis or law. As we shall find upon further examination, ordinary business profits often contain large amounts of what are essentially capital gains, while large amounts of so-called capital gains are little or no different from ordinary profits, or arise indirectly from the accumulation of ordinary income.

Moreover, although the general distinction offers a rough guide to the legal concept of capital gains and losses, the effective legal definition has varied from time to time in the United States and in other countries. The profits and losses arising from short term transactions in capital assets, for example, have frequently been excluded from the legal category of capital gains and losses. In addition, the dividing line between short and long term transactions has at different times been 24, 18, 12, and 6 months in the United States. In Sweden the dividing line is 10 years for real estate and 5 years for other capital assets. The point at which the owner of any kind of capital assets ceases to be merely an investor and becomes, in the eyes of the law, engaged in buying and selling them (and his capital gains become, for tax purposes, ordinary profits), is by no means always clear and has been the subject of much litigation. . . .

3. Are Capital Gains Income?

Whether capital gains should be taxed as ordinary income, taxed at lower rates, or excluded from taxable income has been the subject of more or less continuous controversy in the United States. In favor of taxing capital gains like ordinary income it has been argued that they produce an equal increase in an individual's economic power: the ability to command economic resources and direct them into channels of his own choosing. Like ordinary income, realized capital gains may be spent or saved. Used for consumption, they enhance the ability of a man to build or buy a bigger house, to give his family more expensive clothes, food, and amusements, and to provide his children with superior educational opportunities. As savings, capital gains can be converted into bank balances, bonds, stocks, and other titles to wealth in precisely the same manner and degree as wages and salaries, interest, rent, and ordinary profits. Even when capital gains have not yet been "realized" by sale — while they are still in the form of paper profits, so-called — they constitute additions to the economic resources of those who enjoy them. For even in this form they supply approximately the same increase in economic power, excluding the effects of taxes, as an equal amount of wealth obtained by accumulating and investing ordinary income. In analogous ways, capital losses may be said to reduce the economic power of those who suffer them and, therefore, to be valid deductions from ordinary income.

But no less positive have been the protests of those who hold that capital gains and losses should be completely excluded from income tax on the ground that they are not true elements of income. Unlike most kinds of ordinary income, capital gains occur irregularly in the lives of most individuals. A prudent man does not consider them available for ordinary consumption purposes both because they cannot confidently be expected to recur and because they may well be followed by sporadic losses. A capital gain, therefore, is commonly regarded as a direct addition or accretion to a man's capital, not a part of his disposable income.

Moreover, capital assets derive their value from the incomes that are expected from them, and these incomes are subject to tax when received. A rise in the value of a capital asset often reflects merely a rise in the income expected from it. To tax both the increase in income when it is received and the rise in the market value which merely reflects this expected increase in income is really to tax the same thing twice, it is argued. Of course, the owner gives up the enlarged prospective income from the capital asset when he sells it to "realize" his gain; but he will presumably reinvest the entire proceeds, minus taxes, at the going rate of

return and will therefore continue to obtain and pay taxes on the enlarged income reflected by his capital gain.

Also, if we tax the seller's capital gain as income, are we not treating him unfairly as compared with the owner who does not sell but who equally enjoys the enlarged income?

Further, most capital gains arise over periods longer than 1 year, often many years. To treat them as the income of the single year in which they are realized subjects the recipient to a higher tax than would be payable on an equal amount spread over the number of years in which the gain developed.

Finally, to mention only one of several other aspects in which capital gains differ from ordinary income . . . , it is contended that capital gains do not represent as much taxpaying capacity as an equal amount of ordinary income because they are sporadic, as compared with the recurring character of most types of ordinary income.

The last two points can be illustrated by a comparison. The annual income of James Peters of Cleveland, Ohio hovered about $3,000 for many years. In 1951, besides his ordinary income of $3,000, he realizes a capital gain of $15,000 by selling the house he bought 30 years before to a company that plans to erect an automobile service station on the land. Should Mr. Peters be taxed in 1951 as if his income were $18,000? Does his taxpaying capacity equal that of his sister whose 1951 income of $18,000 was derived wholly from $720,000 par value of 2½ percent Treasury bonds bequeathed her by her husband?

Powerfully supporting the view that capital gains and losses are not true elements of income has been the example of Great Britain, Canada, Australia, and most European countries with respect to capital gains realized by individuals outside the course of their ordinary business activities.* A long tradition in European thought and law has excluded most casual and irregular gains, particularly from the sale of capital assets, from the prevailing concept of personal income and, therefore, from the taxable income of individuals. Besides the force of example, some of the same historical influences and logical considerations that produced this attitude in Europe have been influential in the United States.

But some capital gains are different only in form from ordinary income. An investor who buys a 30-year 3 percent corporation bond at 90 is actually getting an interest return of about 3.55 percent annually; but his return will take the *form* of an interest income of 3 percent a year and a capital gain of about $100 per $1,000 bond at maturity.†

Reinvested corporate profits

Capital gains that appear to reflect the direct reinvestment of profits by corporations have raised an especially troublesome question. Because the law conceives a business corporation as an entity separate and distinct from its stockholders, corporate profits are not regarded as the income of the latter unless and until they receive them in dividends. Consequently, stockholders can postpone or avoid the ordinary personal income taxes upon their proportionate shares of retained corporate earnings. But if these retained earnings are profitably employed by the corporation, stockholders can reasonably expect to obtain some proportion of them — though often only a surprisingly small proportion — in the

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* For the British practice, under which capital gains (defined more narrowly than in the United States) are in general exempt from income tax, see Brudno and Hollman, The Taxation of Capital Gains in the United States and the United Kingdom, 1958 Brit. Tax Rev. 26 and 134. — Ed.

† The possibility of reporting profit of this type as capital gain has been much reduced by subsequently enacted legislation. Infra page 520. — Ed.

form of a capital gain taxable at a preferentially low rate when they sell the stock. Meanwhile, they can expect to enjoy a rise in the earning power and market value of their holdings. Even the capital gains tax will be avoided and the share of these stockholders in the accumulated earnings of the corporation will never be subjected to personal income taxes if they never sell the stock but leave it to their heirs or give it away during their lifetimes to charitable or other tax-exempt institutions or to persons who leave it to *their* heirs. . . .

On the other hand, some reinvestment of earnings may be essential to enable an enterprise merely to maintain its competitive position and its earning power. Accounting charges for obsolescence are often absent or insufficient, with the consequence that the reported earnings often overstate what later are seen to have been the true earnings. Most individual shareholders in large corporations cannot expect to influence dividend policies greatly. They seldom regard their pro rata share in the undistributed earnings of their corporations as a part of their individual incomes. They cannot confidently expect their holdings to increase in market value by the exact amount of earnings reinvested on their behalf. Even if such an increase occurs, the stockholder may find it impracticable to convert it into disposable income by selling one or a few shares and regarding the enhanced market value of the remainder as a measure of the maintenance of the principal of his investment. The scale of brokers' commission charges makes the sale of a few shares of stock relatively expensive, and the market value of a single share may greatly exceed the amount of corporate earnings being reinvested on behalf of the remainder of the investor's holdings. For these and other reasons, the market is likely in many cases to appraise reinvested corporate earnings at less than face value. The question of the proper tax treatment of capital gains comes into contact at this point with the whole question of the tax treatment of corporate profits.

TAX ADVISORY STAFF, TREASURY DEPARTMENT, FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES

9-10, 12-14, 21-22 (1951)

The capital gain and loss provisions of the Federal taxes on individual and corporate income have been controversial since their enactment. Opinion concerning these provisions has ranged from one extreme, that capital gains and losses should be completely excluded from the bases for income taxation, to the other, that these gains and losses should be treated for tax purposes precisely like any other positive or negative elements of ordinary income.

Prior discussion regarding taxation of capital gains has devoted considerable attention to the question whether these gains are capital or income. Opponents of the tax state that capital gains are not income and therefore should not be subject to income tax. Proponents of capital gains taxation believe these gains are sufficiently indicative of taxpaying ability, at least when realized, to be properly subject to income tax.

Since 1922, Congress, while consistently upholding the general principle that capital gains are proper objects of income taxation, has followed an intermediate course in determining the rates of tax to be applied. Although varying in detail, this has included the following main characteristics: (1) Inclusion of capital gains and losses for tax purposes only when realized by sale or exchange; (2) application of special low tax rates to capital gains accrued over more than a minimum period prior to realization; and (3) limitations on deductibility of capital losses from ordinary income. . . .

Basically, the problem of capital-gains taxation is difficult because of the realization criterion of taxability. Under this rule, the taxpayer himself determines when

his gains and losses shall be brought to account. Thus taxpayers have the option to postpone tax liability simply by holding gains unrealized, i.e., by not selling or exchanging their appreciated property. Conversely, they can obtain immediate tax reduction (subject to the limitations already described) by the sale or exchange of capital assets on which losses have accrued. Tax considerations, therefore, reinforce the normal tendency of investors to take losses promptly while letting gains accumulate.

The aggregate of capital gains realized by sale or exchange in any given year will have accrued over a broad range of holding periods — from a few days to many years. There has been widespread acceptance of the general principle that it is unfair to tax at progressive rates, in a single year, capital gains which have accrued over a number of previous years. Concentration of such long accrued capital gains for tax purposes in the year of realization tends to push some taxpayers into higher rate brackets and to make effective tax rates on some gains higher than would have been the case had the taxpayer been allowed to apportion his gains back, either to the actual years of accrual or to some arbitrary period, such as 5 years. Preferential tax treatment for long-term capital gains has always been justified in part by this effect. However, the amount of tax preference given long-term gains has generally been substantially greater than the amount of tax rate adjustment required by this equity consideration.

In addition to the averaging objective in preferential treatment of long-term capital gains, a low rate of tax is often deemed necessary to encourage prompter realization of these gains. The desire to avoid income tax strengthens the natural tendency to hold on to investments. If existing provisions for capital gains taxation have the effect of unduly retarding realization, this may be due as much to defects in the capital gains tax structure, for example, to the fact that capital gains may be transferred free of income tax at death, as to the mere existence of the tax.

The holder of an appreciated capital asset who would like to switch to some other investment must find an alternative that he considers sufficiently preferable to his present holding to offset the tax and other costs (brokerage, etc.) of the exchange. The tax cost is dependent on the rates of capital gains taxation; these in turn vary with the amount of accumulated gain and with the size of the taxpayer's ordinary income. Any significant tax on capital gains levied at the time of realization will undoubtedly tend somewhat to discourage sales of appreciated property. The higher the tax rate, the stronger this effect will be. However, the tax factor is only one among a number of considerations influencing investment decisions. It may be much less important to a given investor than his forecast of future price and other economic trends.

The question of the proper levels of preferential rates to apply to long-term gains is complicated by the conflicting considerations involved. In general and unless capital gains are very large relative to ordinary income, only moderately preferential rates are usually needed for the majority of long-term capital gains in order to make appropriately equitable adjustments for the greater lumpiness and more sporadic nature of these gains compared with ordinary income. On the other hand, if minimum interference with markets for capital assets rather than tax equity is the standard, a relatively low set of tax rates for long-term capital gains may be indicated. If maximum revenue from capital gains taxation is the standard, an intermediate schedule of rates, which does not too greatly restrict transactions and at the same time does not encourage an excessive amount of conversion of ordinary income into preferentially taxed long-term capital gains, may be desirable. Moreover, intermediate rates may be held to effect a reasonable compromise between the conflicting equity and market considerations.

Finally, any generally acceptable solution of the capital-gains tax problem might

require complex tax provisions. It is important for administration and compliance that these complications be kept to a minimum. In the past, Congress has sought as much simplicity as was consistent with prevailing views concerning the objectives of capital-gains taxation. . . .

Preferential treatment of capital gains has been justified on several grounds, namely, equity, incentive, and revenue yield.

With respect to equity, it has been pointed out that it is unfair to include with other income and to tax at progressive rates in the year of realization capital gains which have accrued over a number of previous years. It has become more or less generally accepted that an equitable principle of taxation for capital appreciation under an annual income tax would be one under which the tax on capital gains levied upon realization would approximate that which would have been paid if the gain or loss, treated as ordinary income or loss, had been realized as it accrued annually.

One of the earliest proposals for special treatment of capital gains which received the serious consideration of Congress provided for prorating realized capital gains, together with certain other types of income, over the years during which the capital asset had been held or the other income earned. This method was rejected, however, as too complicated for administration.

Consideration has also been given at various times to such proposals as (1) the inclusion in taxable income of annually accrued though unrealized gains and losses, and (2) proration or averaging of realized capital gains, either separately or with other income, over several years — not necessarily the number of years the capital assets have been held. These methods were likewise rejected largely because of administrative and compliance complexities, but also in part because of constitutional questions and fear of causing taxpayer hardship.

Throughout the history of capital-gains taxation, continuous concern about the effects of the tax on (a) sales and exchanges, (b) security and other property prices, and (c) revenue yield has been apparent. It was the belief that a moderate tax rate would encourage the sale of much appreciated property which otherwise would not be sold that provided the main foundation of the case for the introduction of preferential treatment in 1921.

Congress has tried time and again to find a method, both practicable and equitable, of taxing capital gains. Such a method has been conceived to be one which would interfere as little as possible with realization of gains and at the same time would not stimulate loss realization too much.

But finding satisfactory formulas for achieving the divergent equity and incentive objectives that are entwined in the philosophy of capital-gains taxation and at the same time protecting the revenue has been a difficult problem. Consequently, the history of the legal provisions has been a record of compromise and change without satisfactory solution.

NEW YORK STOCK EXCHANGE, TAXES — EQUITY CAPITAL — AND OUR ECONOMIC CHALLENGES

38-40 (1953)

Tax treatment of capital gains and losses has changed from time to time in an effort to reconcile various unresolved conflicts between equity considerations, revenue requirements, and the desire to avoid reducing investment incentives and the marketability of capital assets.

Taxation of capital gains provides the federal government with only a small portion of its total tax revenue. . . . The depressive effects of the present capital gains tax on investment incentives alone far outweigh, in their economic implications, the amount of revenue this tax provides.

Several special factors peculiar to capital gains taxation are pertinent to a precise understanding of its important economic implications:

1. *Tax Liability is Matter of Choice.* To incur capital gains tax liability is a voluntary act undertaken at the discretion of the taxpayer. Therefore, even modest tax rates have the general effect of inducing many investors not to sell or exchange their capital holdings, which, in turn, means reduced tax revenue, restricted market activity, and impaired mobility in capital movement.

2. *Periodic Fluctuations in Security Values.* One of the fundamental characteristics of a free securities market is its sensitivity to the diverse factors which influence investors' evaluations of their future interest and future price movements. Changes in the economic climate, both in this country and abroad, changes in our political or economic relations with other countries, new discoveries, sudden increases in product popularity, and many other factors, can substantially affect security prices in a period as brief as a few days or as long as several months. Many instances of this sensitivity are observable in the price movements of individual and industry-wide stock issues, even when overall market averages are steady. But today's capital gains tax law (with a six-month holding period) unfortunately prevents many security transactions of a non-speculative nature which would otherwise be made if the holding period were less than six months.

In a study of public stock transactions made by the New York Stock Exchange, it was found that 806,000 shares were sold at a gain by "public" individuals (that is, persons other than members or allied partners of the New York Stock Exchange), on the two days surveyed. The following percentages of the shares sold had been held for the indicated periods of time: under 30 days, 3 per cent; 30 days to 6 months, 20 per cent; 6 months to one year, 26 per cent; over one year, 48 per cent; no indication, 3 per cent. From these data it seems fair to conclude that a substantial number of the delayed transactions — certainly a large part of the 26 per cent held for 6 months to one year — were deferred for the express purpose of meeting the holding period provisions of the capital gains tax law.

It was not the intent of Congress when it set up the holding period that it should act as a barrier against sound investment transactions. It was rather an arbitrary device designed to help distinguish between capital gains deserving special tax treatment and gains which are so close to being ordinary income that they should be taxed as such. As such, however, the six-month holding period is too long, and has proven unnecessarily restrictive. A period of three months would be a more desirable dividing line because:

1. It would differentiate as well as the present six months period between those capital transactions deserving of special treatment and those which should be taxed as ordinary income.
2. It would be as workable administratively.
3. By permitting the freer exercise of investment judgment, it would result in thousands of additional transactions in capital assets, and result in substantial additional government revenues.
4. It would increase the liquidity of the securities markets, thus providing needed encouragement to equity investment.

3. *Price Level Changes and "Locked-In" Capital.* The substantial increase in the general price level in the last two decades has resulted in much capital appreciation. Because of this general increase in price levels the proceeds of the realization of such gains are largely "illusory" in terms of real value. Nevertheless any realized gains, whether real or not, are subject to tax liability. But, since the tax is self-imposed, an investor who regards his gains as fictitious can avoid it by not shifting his investment. The result is a "freezing" or "locking-in" of large sums of capital which otherwise could be of more productive use if put into newer, or different industries.

4. *Taxing Transfers of Permanently-Invested Equity Capital.* An established principle of tax policy has been to permit the tax-free transfer of certain assets similar in kind, such as farms, real estate, livestock, etc. The tax laws, in the Revenue Act of 1950, extended this principle by permitting the tax-free shifting of personal residences.

The above principle of taxation would be even more valuable to the national economy if it were applied to equity funds as long as they remained invested in productive enterprise. It would eliminate a major cause of investment-fund stagnation since, at present, the transfer of investments are undertaken, in a great many cases, only when the asset purchased yields a substantially higher return than did the one being liquidated.

5. *"Roll-Over" Proposal.* One suggestion, which has been considered from time-to-time, would apply this principle of tax-free transfers of assets similar in value and in kind to all forms of capital reinvestment.* This suggestion, sometimes termed the "roll-over" proposal, would have the effect of deferring the capital gains tax until *final* "realization" of the capital asset. Thus, for example, an investor would *not* be taxed if he sold one security for the purpose of purchasing another within a given period of time, or sold a farm, timberland, etc., for similar reinvestment of the proceeds.

A tax liability would be incurred only on that portion of capital *not* reinvested in productive enterprise, or *not* reinvested in similar types of capital assets.

Although this proposal would provide more equitable treatment for certain types of capital transactions, it would not be a complete solution and would also involve tremendous administrative complexities. The more practical immediate solution would appear to be a substantial lowering of the rate and a shortening of the holding period to permit such transfers to be made without today's excessive tax impact.

6. *Inflationary Effect of Capital Gains Tax on Security Prices.* The effect of the present capital gains tax in keeping large quantities of stock off the market can be an additional inflationary factor of considerable significance in a period of high or rising prices. Moreover, the impact of the tax under such conditions becomes even greater as prices continue to rise — which is when, in the interest of price stability, stockholders should be encouraged to liquidate holdings rather than retain them.

NOTE

The following is from an article entitled "Capital Gains Tax 'Freezes In' Few," by Burton Crane, in the New York Times, Feb. 5, 1956, §3, p. 1, col. 4:

> No financial subject has caused more regrettable misunderstanding than the capital gains tax. Investors who should know better will report with every show of sincerity that the tax "freezes" them into their holdings.
>
> Actually, only investors who expect to die in the near future are "frozen in." Death provides a new capital gains basis, the market price at the time. A man about to die would be foolish to pay a 25 per cent long-term capital gains tax this week and have his estate pay perhaps 30 per cent more in inheritance tax.
>
> But nobody else is "frozen in."
>
> This is probably a case in which propaganda has been believed by the wrong persons. Wall Street intended it for Congress, hoping to get rid of the tax or to have it reduced. Instead, it was believed by Wall Street's customers. There is no doubt that the feeling of being "frozen in," false though it is, has kept many an investor from realizing his gains.

* For one such proposal, see Clark, An Alternative to Capital Gains Taxation: A "Roll-Over" Account for Investment Assets, 4 How. L.J. 157. — Ed.

SIMONS, FEDERAL TAX REFORM *

70-71 (1950)

The capital-gains problem has now three important aspects. First, accrued gains on property held until one's death are never reached as taxable income at all. Second, gains realized by sale are only partially taxable and, besides, are subject to a maximum rate far lower than the maximum rate on other income. Third, deductions for capital losses are limited and segregated, so that, while those who have net capital gains are grossly undertaxed, those who have net capital losses are often grossly overtaxed. Limited deduction for losses is actually inseparable politically from limited inclusion of gains; but to regard the two limitations as offsetting is to repudiate the primary purpose of income taxation, namely, fairness among persons. It is indeed a shabby apology for present practice that, if it obviously undertaxes some persons, it obviously overtaxes others.

Even if one overlooks the major flaw, namely, failure to reach gains on property transferred by gift or at death, the limited taxation of realized capital gains is obviously inconsistent with our whole scheme of progression. *It is inherently unjust to impose any bracket rate in excess of the maximum rate applicable to capital gains.* In the long view, we must either abandon progression or abandon special treatment of capital gains and losses. This should be too obvious for argument, now that even the huge salaries and bonuses of corporation executives are often converted into a capital-gain form, by the device of the option to purchase the corporation's stock. The logical conclusion of recent trends in legislation is a blanket option for every taxpayer to treat any income as capital gain, if and as he so desires. This option would give us an effective maximum rate about equal to the minimum or basic rate; and Congress could then manipulate the rest of the surtax scale as it pleased and without any effect on anybody! But the scheme would have the great merit of imposing similar taxes on people in similar circumstances.

NOTE

1. *What are "capital gains"?* In speaking of "capital gains," the authors of the foregoing materials are primarily referring to gains on the sale of corporate stock and securities. But do they mean to include only the casual investor or would they grant the same special treatment to the transactions of one who makes his entire living by "playing the market"? Would they include even the dealer who maintains a regular office, with a large clientele, for the purchase and sale of securities? What other kinds of property should get special treatment? Real estate? Used machinery and equipment? Patents? Contract rights? Merchants' inventories? Should the special treatment be restricted to property that has been sold? What if the property has been stolen or destroyed?

These questions, and a host of others like them, must be answered, once it has been decided to grant special treatment to "capital" gains and losses. Occasionally the statute answers the question clearly, but more frequently the lawyer must be called in. The cases that follow focus on the statute, of course, but the student should also ask himself in each case whether the income or loss *ought* to be treated specially.

2. *Some statistics.* During the period 1948-1960, the tax on capital gains and losses accounted for 2.4 to 5.8 per cent of the total federal income taxes paid by individuals and fiduciaries and for 1.4 to 3.2 per cent of the total paid by corporations. If these figures suggest that the special treatment of capital gains and losses is of minor importance, a necessary corrective is supplied by the fact that in 1959 long-term capital gain represented 31.5 per cent of the total income realized by individual taxpayers with

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$100,000 to $150,000 of income, 50 per cent of total income for taxpayers in the $200,000-500,000 bracket, and 63 per cent for those above $500,000.

For these and other relevant statistics, see Treasury Department, Statistics of Income, Sales of Capital Assets Reported on Individual Income Tax Returns, 1959; Exhibit 10 of Treasury Statement, Hearings on H.R. 8363 (proposed Revenue Act of 1963), Senate Finance Committee, 88th Cong., 1st Sess. 193 et seq. For estimates of unrealized capital gains, see Steger, The Taxation of Unrealized Capital Gains and Losses: A Statistical Study, 10 Nat. Tax J. 266 (1957); Cloe, Capital Gains and the Changing Price Level, 5 id. 207 (1952).

3. *References.* Surrey, Definitional Problems in Capital Gains Taxation, 69 Harv. L. Rev. 985 (1956); Miller, The "Capital Asset" Concept: A Critique of Capital Gains Taxation: I and II, 59 Yale L.J. 837, 1057 (1950); Lowndes, The Taxation of Capital Gains and Losses Under the Federal Income Tax, 26 Texas L. Rev. 440 (1948); Wells, Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948, 2 Nat. Tax J. 12 (1949); and, for a view into the future, Blum, The Decline and Fall of Capital Gains: 1921-1957, 28 Taxes 838 (1950).

The principal arguments for and against taxing capital gains as ordinary income are summarized by Blum, A Handy Summary of the Capital Gains Arguments, 35 Taxes 247 (1957). For more detailed comments on the policy issues by various authors, see Tax Revision Compendium 1193-1299 (House Committee on Ways and Means, 1959); Federal Tax Policy for Economic Growth and Stability 367-404 (Joint Committee on the Economic Report, 1955); Tax Institute, Capital Gains Taxation (1946); see also Somers, Capital Gains Tax: Significance of Changes in Holding Period and Long Term Rate, 16 Vand. L. Rev. 509 (1963); Somers, Reconsideration of the Capital Gains Tax, 13 Nat. Tax J. 289 (1960), and articles there cited; Katcher, A Critique of Capital Gains Taxation: Problems and Proposals, 1962 So. Calif. Tax Inst. 769.

British views on taxation of capital gains may be found in Royal Commission on Taxation of Profits and Income 25-40, with dissent at 365-382 (final report, 1955).

STATEMENT OF SECRETARY OF THE TREASURY DILLON, RE: PRESIDENT KENNEDY'S 1963 TAX MESSAGE

Hearings on H.R. 8363 (Proposed Revenue Act of 1963)
House Committee on Ways and Means, 88th Cong., 1st Sess. 47-51 (1963)

One of the most important phases of the tax law in which the President has recommended changes designed to release the forces of growth is the treatment of capital gains and losses.

This part of the tax system has not undergone needed basic revision since 1942. The present provisions are both inequitable in essential respects and detrimental to the mobility of investment funds and liquidity in capital markets. The broad definition of capital gains permits certain types of ordinary income to be taxed at capital gains rates, thus making it more difficult to set an appropriate rate of taxation for true capital gains.

An overhaul of these provisions can make an important contribution to a stronger economy and a fairer tax system. Reduction of tax barriers to the free flow of investment and risk capital will not only add to the strength and buoyancy of the economy but will also produce several hundred million dollars of additional revenue annually. . . .

Percentage inclusion

The President has recommended that the percentage of long-term capital gains included in taxable income of individuals be reduced from the present 50 percent of the gain to 30 percent. In combination with the proposed individual income tax rate [reductions], this will result in capital gains tax rates ranging from 4.2 percent to a maximum of 19.5 percent, compared with an existing range of 10 to

25 percent. It will result in more equal treatment of individuals in various income groups. Unlike the present arrangement, the relative differential between capital gains tax rates and ordinary income tax rates would be the same at all levels of income.

While this would provide a reduction of 22 percent in the capital gains tax for those in the highest bracket, the reductions would be substantially greater for all other taxpayers. For instance under present law the 25 percent rate applies whenever ordinary taxable income plus capital gains exceeds $16,000 for a single individual and $32,000 for a married couple. At this same level the effective rate under the President's proposals would be only 12 percent. . . .

Independent outside surveys, our own studies, and letters and comments which are received daily from taxpayers throughout the country indicate clearly that these substantial reductions will increase taxpayers' willingness to realize capital gains and stimulate a larger turnover of capital assets.

Thus the recommended 30 percent inclusion ratio would stimulate a freer flow of investment funds and at the same time provide a more even-handed treatment of taxpayers in all income brackets.

Capital gains of corporations

Corporations should share in the reduction in capital gains tax rates. In line with the reduction of general corporate tax rates, the President has recommended that the present basic structure of capital gains taxation for corporations be retained but that the alternative rate be reduced from the present 25 percent to 22 percent. The 22 percent rate corresponds to the proposed reduced corporate normal tax rate. This will simplify tax accounting for capital gains for almost half a million corporations subject only to the normal tax.

Holding period

The present preferential treatment of assets disposed of within a period of less than a year is difficult to justify either on economic or equity grounds. The 6-month holding period frequently qualifies purely speculative profits. It also makes it less risky to carry out various maneuvers designed to convert ordinary income into capital gains.

A longer holding period makes it possible to provide more liberal treatment for bona fide investment gains without applying unjustified reductions to income from short-term trading in securities. Moreover, the substantial reduction in ordinary income tax rates must be taken into account in considering the proper holding period, as even short-term gains will be taxed at lower rates.

It is for these reasons that the President has recommended that the holding period be lengthened from 6 months to 1 year.

Capital loss carryover

Under existing law, net capital losses of up to $1,000 incurred in any one year may be charged against ordinary income in that year. Any remaining loss may then be carried forward for 5 years as a short-term capital loss, applicable first against capital gains and then available as an offset to ordinary income to the extent of $1,000 in each of the 5 years.

Large investors with diversified portfolios are generally in a position to balance out gains and losses within the 5-year period. The 5-year limitation, however, frequently works a hardship on the smaller investor who sustains a considerable loss and cannot fully match it either with capital gains or the $1,000 annual income offset. Permitting unabsorbed capital losses to be carried forward for an indefinite period, as recommended by the President, would improve the equity

of the capital gains tax, provide greater assurance to the small investor that capital losses he may sustain will eventually be absorbed by capital gains or other taxable income, improve investment odds for the risk-taker, and increase the effective supply of investment funds for growth.

Equal treatment of gains accrued on capital assets at time of transfer by gift or at death

Present law permits the exemption from income tax of capital gains accrued when the appreciated assets are transferred at death. The prospect of eventual tax-free transfer of accrued gains with a stepped-up basis equal to the new market value in the hands of heirs distorts investment choices and frequently results in complete immobility of investments of older persons.

The President has recommended that the proposed reduction in the capital gains tax be accompanied by the taxation at long-term capital gain rates of net gains accrued on capital assets at the time of transfer at death or by gift. This would not apply to assets transferred as charitable gifts or bequests.

This recommendation is an essential element of the overall program of substantial reduction in capital gains tax rates. The reduction in capital gains tax rates alone would not effectively deal with the "lock-in" problem. Without this broader, more equal capital gains tax base, there would be no justification for lowering capital gains tax rates.

This proposal would be accompanied by several features that would effectively eliminate hardships that might otherwise arise. Let me outline these features.

First, the capital gains tax would reduce the base of the estate tax, so that for the largest estates the incremental tax on accrued gains would be only 4½ percent.

Second, all ordinary personal and household effects such as clothing, appliances, and furniture would be exempt.

Third, I have already mentioned the continued exemption for property passing to charity.

Fourth, a marital deduction would be provided similar to related provisions of the estate and gift taxes so as to assure uniformity in the treatment of residents of community property and common law States. It would be necessary in case of the marital deduction to provide for a carryover of the original basis so that the tax could eventually be collected.

Fifth, an additional blanket exemption of $15,000 of gain would apply to every taxpayer.

Sixth, special provisions would integrate the exemption of a principal residence with the marital deduction and the $15,000 exemption. These would insure that no one would have to pay tax on the transfer of a home to a surviving wife or husband, or if there were none, to children or other heirs.

The foregoing exceptions and exemptions would limit any impact whatsoever of the proposal to fewer than 3 percent of those who die each year. A number of other provisions set forth relief and transition rules. These rules when combined with the reduced rates of tax on capital gains and integration with the estate tax, will in most cases mean that taxpayers with capital gains will pay much lower aggregate taxes on those gains over their lifetimes than under present law. These rules are:

First, a 5-year averaging provision would be applicable to limit the tax on gain at death to five times the tax on the first one-fifth of the gain.

Second, accrued losses at death would be fully utilized through a special carryback provision.

Third, to help those estates with liquidity problems certain provisions of present law, permitting installment payment of estate taxes and redemptions of cor-

porate stock without dividend consequences, would apply to the capital gains tax on transfers at death. These provisions should also be liberalized both for estate tax and capital gains purposes, so as to more adequately accomplish the purpose for which they were designed.

Fourth, provision should be made to enable taxpayers to accommodate their estate plans to the new rules through an appropriate transition device. One way in which this might be accomplished would be to set a 3- or 5-year transition period. If a 5-year period were used, the estate of a person dying in 1964 would pay tax on one-fifth of the gains on transfer at death, that of a person dying in 1965 on two-fifths, and so on, with full taxation applying in 1968. A 3-year period would operate in similar fashion, providing full taxation by 1966.

More complete details of how these proposals would operate are set forth in the technical explanation [Hearings, pp. 128 et seq.]. This explanation also illustrates its impact on the estates of representative decedents. It shows that a decedent with an estate of $105,000, with $30,000 of appreciation, would pay neither estate nor income tax. A decedent with an estate of $350,000 and $210,000 of appreciation, almost two-thirds of his estate, would pay additional taxes on account of the $210,000 appreciation of $5,452 — 1.6 percent of his gross estate. A decedent with a $5 million estate and $2 million of appreciation would pay additional taxes of $76,580 — the $2 million of appreciation being taxed at an effective rate of 3.8 percent.

In each of these illustrations, however, the additional taxes, if any, at death would be more than offset by the new lower capital gains rates, if any significant amount of gains were realized during lifetime.

Thus the new treatment of capital gains will result in seriously heavier taxation for none, lower taxation for most, and more equitable treatment for all. At the same time, through the effect of lower rates coupled with the removal of the "lock-in" effect of the present law, it will add substantially to revenues both directly and indirectly by encouraging far greater mobility and turnover of appreciated assets.

Definitional changes

The President's recommendations in this area call for tightening of the definition of capital gains designed to reverse the trend, inspired by wartime increases in tax rates, toward the progressive extension of capital gains treatment to a variety of ordinary income sources.

Proposed reductions in ordinary income tax rates make the redefinition of capital gains desirable and feasible. It is made imperative by the substantial reduction in the tax rates applicable to true capital gains.

The existing scope of the capital gain area has led to widespread economic distortions and tax avoidance techniques. In the absence of corrective action these would tend to be intensified by the lower capital gains rates.

[The proposed definitional changes would have restricted or eliminated capital gain treatment for employee stock options, real estate transactions, mineral interests, timber income, lump sum distributions by pension and profit-sharing plans, livestock, citrus groves and similar farm property, patents, royalties, installment sales, and life estates.]

Overall effects

Enactment of the President's recommendations for reduction and reform in the capital gains area would substantially reduce the amount of tax paid per dollar of capital gain realized. At the same time, the improved definition of capital gains, the extension of the holding period, and the taxation of capital gains at

death will result in a net increase in revenue from this source of $100 million. In addition, a substantial increase in revenue, estimated at $650 million, will be realized as a consequence of the unlocking effects of the proposals and the greater volume of capital transactions that can be confidently anticipated. The total increase in revenue from the capital gains proposal is, therefore, about $750 million per year.

NOTE

The legislative recommendations set out above encountered stormy weather on Capitol Hill. As enacted by the House of Representatives, the bill (which became the Revenue Act of 1964) did not alter the capital gain rate for corporations, but for individuals the maximum rate was reduced to 21 per cent (from 25 per cent) for capital assets held for more than 2 years. The realization-at-death provision recommended by President Kennedy was rejected, along with a last minute alternative proposal for a carryover of basis under which the heirs of a decedent would sometimes be required to use the decedent's basis, rather than the value at date of death. The administration then announced that the proposed rate reduction was unacceptable unless accompanied by either realization at death or a carryover of basis; and the Senate responded by eliminating the rate reduction.

As to the other 1963 recommendations in this area, the proposed unlimited carryover of unused net capital loss was enacted for individual taxpayers, but not for corporations, and definitional changes — less sweeping than recommended — were enacted that affect employee stock options, depreciable real estate, and imputed interest on deferred payments for capital assets.

SECTION B. CAPITAL GAINS AND LOSSES: THE MECHANICS OF CURRENT LAW

Although the details have varied from time to time, the persistent themes in the income tax treatment of capital gains and losses have been (a) a favorable tax rate (achieved in various fashions) on capital gains, and (b) restrictions on the deductibility of capital losses. The first step under current law (1964) is to aggregate the taxpayer's long-term capital gains and losses in order to determine his "net long-term capital gain" (or loss), and similarly to aggregate his short-term capital gains and losses to arrive at his net "short-term capital gain" (or loss). See §1222. In general, long-term gains and losses are those involving assets held by the taxpayer for more than six months, while short-term gains and losses involve assets held for six months or less. In a few instances, however, the Code arbitrarily assigns a transaction to one category or the other regardless of the taxpayer's holding period (e.g., a loss incurred by an individual when a "nonbusiness debt" becomes worthless is treated by §166(d)(1)(B) as a short-term capital loss). In the explanation that follows, the tax treatment of individuals and other non-corporate taxpayers will be described first; and in the interest of simplicity, it will be initially assumed that the taxpayer's transactions were all either long-term or short-term transactions.

1. *Net long-term capital gain only.* Assuming a net long-term capital gain only, the taxpayer is entitled to deduct 50 per cent thereof from gross income. (Section 1202 authorizes this deduction if "the net long-term capital gain exceeds the net short-term capital loss," but this includes cases in which the taxpayer did not realize any short-term capital losses.) Having ascertained his taxable income with the benefit of this deduction (along with the other deductions to which he is entitled), the taxpayer computes his tax by reference to the regular rate schedule of §1 of the Code. An "alternative tax" is then computed under §1201(b), which

is the sum of (a) a "partial tax" computed at the §1 rates on taxable income reduced by 50 per cent of the taxpayer's net long-term capital gain,* and (b) 25 per cent of the net long-term capital gain. The taxpayer pays either the regular tax or the "alternative tax," whichever is lower. The "alternative tax" computation of §1201(b) cannot be advantageous if the taxpayer's marginal rate of tax under §1 is 50 per cent or less, so single persons with 1964 taxable income of $20,000 or less, heads of households with taxable income of $32,000 or less, and married persons with taxable income of $40,000 or less need not make the alternative computation but can console themselves with the 50 per cent deduction of §1202 in computing their tax under §1. (For 1965, the corresponding critical points are $26,000, $38,000, and $52,000.)

The full amount of the taxpayer's capital gains (not merely the *net* long-term or short-term capital gain) is included in *gross income,* which affects such matters as the filing requirements, the eligibility of certain dependents, the extended statute of limitations of §6501(e), etc.; but his capital losses and the §1202 deduction of 50 per cent of net long-term capital gain are taken into account by §62 in determining *adjusted gross income* (which affects the medical expense and charitable contribution deductions).

2. *Net short-term capital gain only.* The taxpayer's net short-term capital gain is included with his other income in computing gross income, adjusted gross income, and taxable income; and it qualifies for no concession in computing the tax itself. As will be seen, however, net short-term capital gain differs from ordinary income in that it can be offset without limitation by net long-term capital loss.

3. *Net long-term capital loss or net short-term capital loss only.* If the taxpayer has either a net long-term capital loss only or a net short-term capital loss only, it is applied against $1,000 of ordinary income under §1211(b); any excess becomes a capital loss carryover under §1212(b). Before 1964, such a carryover could be used for only five years following the year in which the loss arose, and was to be treated as a short-term capital loss in the years to which it was carried whether it arose from long-term or short-term transactions; and these limitations are still in effect for corporations. As to other taxpayers, however, the Revenue Act of 1964 introduced an unlimited carryover of capital losses, and provided that the long-term or short-term character of the original loss would be preserved in the later years to which the loss is carried.

Turning now to the tax effect of a combination of long-term and short-term transactions when incurred by non-corporate taxpayers, there are the following possibilities:

4. *Net long-term capital gain and net short-term capital gain.* With this combination, the taxpayer's net long-term capital gain and the net short-term capital gain are treated as described in 1 and 2 above, respectively.

5. *Net long-term capital loss and net short-term capital loss.* The net long-term capital loss is combined with the net short-term capital loss for application against $1,000 of ordinary income. The excess, if any, is carried forward under §1212 (b); but the two types of losses revert to their long-term and short-term natures in the later years, and in computing the carryovers, it is assumed that the net short-term capital loss was used to the extent available to effect the $1,000 offset against ordinary income in the year the losses arose. Thus, if in 1964 the taxpayer incurred a net long-term capital loss of $5,000 and a net short-term capital loss of $2,000,

* Since 50 per cent of the net long-term capital gain was deducted under §1202 in arriving at taxable income, the reduction of taxable income by a like amount in computing the "partial tax" means that the "partial tax" is based solely on the ordinary income component of the taxpayer's taxable income.

he would be entitled to deduct $1,000 of the combined loss from ordinary income, and would carry forward a long-term capital loss of $5,000 and a short-term capital loss of $1,000 under §1212(b). If the net short-term capital loss had been $800 (instead of $2,000), the carryover under §1212(b) would be $4,800, to be treated as a long-term capital loss in the succeeding years.

6. *Net long-term capital gain and net short-term capital loss.* If the net long-term capital gain exceeds the net short-term capital loss, the taxpayer follows the procedure described in 1 above, except that instead of the net long-term capital gain he would use the *excess* of net long-term capital gain over net short-term capital loss in computing the §1202 deduction and the "alternative tax."

If the net short-term capital loss exceeds the net long-term capital gain, the gain is wiped out, the remaining loss is applied against $1,000 of ordinary income under §1211(b), and any excess becomes a short-term capital loss in later years under §1212(b).

7. *Net long-term capital loss and net short-term capital gain.* If the long-term loss exceeds the short-term gain, the gain is wiped out, the remaining loss is applied against $1000 of ordinary income under §1211(b), and any excess becomes a long-term capital loss in later years under §1212(b).

If the short-term gain exceeds the long-term loss, the excess is taxed with ordinary income at the regular rates prescribed by §1.

Corporations. Corporations are not entitled to the special deduction of §1202 (50 percent of excess of net long-term capital gain over net short-term capital loss), but are entitled to the "alternative tax" computation of §1201(a). Corporations with taxable income of $25,000 or under thus derive no benefit from the capital gain provisions, since their marginal rate under the regular tax schedule of §11(b) is 22 per cent. (Before 1964, when the corporate normal tax rate was 30 per cent, all corporations benefitted from the 25 per cent rate provided by the alternative tax for the excess of net long-term capital gain over net short-term capital loss.) As to capital losses, they may be applied by corporations only against capital gains; the $1,000 of ordinary income concession of §1211(b) is not granted to corporate taxpayers. Finally, as mentioned above, the carryover of capital losses is limited by §1212(a) to five years if the taxpayer is a corporation, and the amount carried forward is treated as a short-term capital loss in the later years.

* * *

Current law, as outlined above, differs in certain respects from the earlier statutes; and some of the cases must be read with this in mind. The most confusing difference is that during the period 1942-1950, long-term gains and losses were "taken into account" by non-corporate taxpayers only to the extent of 50 per cent, while short-term gains and losses were "taken into account" in full. Thus, a short-term loss of $1,000 would cancel out a long-term gain of $2,000. This system of computing capital gains and losses gave rise to manipulative devices, which in turn evoked legislative counter-measures that are still to be found in the Code. See infra, page 590.

SECTION C. THE "COMMON LAW" OF CAPITAL GAINS AND LOSSES

Section 1222 defines the terms "capital gain" and "capital loss" (long-term or short-term, as the case may be) to mean gains and losses on the "sale or exchange" of a "capital asset." The term "sale or exchange" is not defined, but the Code provides that a number of borderline transactions (e.g., certain redemptions of corporate stock) shall be treated as sales or exchanges (infra p. 584). The term "capital asset" is defined at some length by §1221: it means "property held by the

taxpayer" that does not fall into certain excluded categories (e.g., property held for sale to customers in the ordinary course of the taxpayer's business; certain accounts receivable; etc.). Before turning to the details of this definition, however, we shall examine a number of recent cases in which the courts have held that a transaction produced ordinary income or loss — despite the fact that the taxpayer engaged in a "sale or exchange" of a "capital asset" and thus met the technical statutory requirements for capital gain or loss treatment — because the character of the transaction disqualified it for the "special" treatment accorded to capital gains and losses by Congress. The way in which the courts have recently been groping beyond the letter of the Code in an effort to apply its spirit in this area is reminiscent of the pioneering income-splitting cases that are examined in Chapter IV, although in the capital gain and loss area the courts are working with more detailed statutory provisions that leave less room for judicial free-wheeling. See generally Comment, The Troubled Distinction Between Capital Gain and Ordinary Income, 73 Yale L. J. 693 (1964).

1. *Transactions Related to Taxpayer's Regular Business*

CORN PRODUCTS REFINING CO. v. COMMISSIONER

350 U.S. 46 (1955)

MR. JUSTICE CLARK delivered the opinion of the Court.

This case concerns the tax treatment to be accorded certain transactions in commodity futures.[1] In the Tax Court, petitioner Corn Products Refining Company contended that its purchases and sales of corn futures in 1940 and 1942 were capital-asset transactions under [§1221]. . . .

Petitioner is a nationally known manufacturer of products made from grain corn. It manufactures starch, syrup, sugar, and their byproducts, feeds and oil. Its average yearly grind of raw corn during the period 1937 through 1942 varied from thirty-five to sixty million bushels. Most of its products were sold under contracts requiring shipment in thirty days at a set price or at market price on the date of delivery, whichever was lower. It permitted cancellation of such contracts, but from experience it could calculate with some accuracy future orders that would remain firm. While it also sold to a few customers on long-term contracts involving substantial orders, these had little effect on the transactions here involved.

In 1934 and again in 1936 droughts in the corn belt caused a sharp increase in the price of spot corn. With a storage capacity of only 2,300,000 bushels of corn, a bare three weeks' supply, Corn Products found itself unable to buy at a price which would permit its refined corn sugar, cerealose, to compete successfully with cane and beet sugar. To avoid a recurrence of this situation, petitioner, in 1937, began to establish a long position in corn futures "as a part of its corn buying program" and "as the most economical method of obtaining an adequate supply of raw corn" without entailing the expenditure of large sums for additional storage facilities. At harvest time each year it would buy futures when the price appeared favorable. It would take delivery on such contracts as it found necessary to its manufacturing operations and sell the remainder in early summer if no shortage was imminent. If shortages appeared, however, it sold

[1] A commodity future is a contract to purchase some fixed amount of a commodity at a future date for a fixed price. Corn futures, involved in the present case, are in terms of some multiple of five thousand bushels to be delivered eleven months or less after the contract. Cf. Hoffman, Future Trading (1932), 118.

futures only as it bought spot corn for grinding.[2] In this manner it reached a balanced position with reference to any increase in spot corn prices. It made no effort to protect itself against a decline in prices.

In 1940 it netted a profit of $680,587.39 in corn futures, but in 1942 it suffered a loss of $109,969.38. In computing its tax liability Corn Products reported these figures as ordinary profit and loss from its manufacturing operations for the respective years. It now contends that its futures were "capital assets" under [§1221] and that gains and losses therefrom should have been treated as arising from the sale of a capital asset. In support of this position it claims that its futures trading was separate and apart from its manufacturing operations and that in its futures transactions it was acting as a "legitimate capitalist." United States v. New York Coffee & Sugar Exchange, 263 U.S. 611, 619. It denies that its future transactions were "hedges" or "speculative" dealings as covered by the ruling of General Counsel's Memorandum 17322, XV-2 Cum. Bull. 151, and claims that it is in truth "the forgotten man" of that administrative interpretation.

Both the Tax Court and the Court of Appeals found petitioner's futures transactions to be an integral part of its business designed to protect its manufacturing operations against a price increase in its principal raw material and to assure a ready supply for future manufacturing requirements. Corn Products does not level a direct attack on these two-court findings but insists that its futures were "property" entitled to capital-asset treatment under [§1221] and as such were distinct from its manufacturing business. We cannot agree.

We find nothing in this record to support the contention that Corn Products' futures activity was separate and apart from its manufacturing operation. On the contrary, it appears that the transactions were vitally important to the company's business as a form of insurance against increases in the price of raw corn. Not only were the purchases initiated for just this reason, but the petitioner's sales policy, selling in the future at a fixed price or less, continued to leave it exceedingly vulnerable to rises in the price of corn. Further, the purchase of corn futures assured the company a source of supply which was admittedly cheaper than constructing additional storage facilities for raw corn. Under these facts it is difficult to imagine a program more closely geared to a company's manufacturing enterprise or more important to its successful operation.

Likewise the claim of Corn Products that it was dealing in the market as a "legitimate capitalist" lacks support in the record. There can be no quarrel with a manufacturer's desire to protect itself against increasing costs of raw materials. Transactions which provide such protection are considered a legitimate form of insurance. United States v. New York Coffee & Sugar Exchange, 263 U.S., at 619; Browne v. Thorn, 260 U.S. 137, 139-140. However, in labeling its activity as that of a "legitimate capitalist" exercising "good judgment" in the futures market, petitioner ignores the testimony of its own officers that in entering that market the company was "trying to protect a part of [its] manufacturing costs"; that its entry was not for the purpose of "speculating and buying and selling corn futures" but to fill an actual "need for the quantity of corn [bought] . . . in order to

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2 The dispositions of the corn futures during the period in dispute were as follows:

	Sales of futures thousand bushels	Delivery under futures thousand bushels
1938	17,400	4,975
1939	14,180	2,865
1940	14,595	250
1941	2,545	2,175
1942	5,695	4,460

cover . . . what [products] we expected to market over a period of fifteen or eighteen months." It matters not whether the label be that of "legitimate capitalist" or "speculator"; this is not the talk of the capital investor but of the far-sighted manufacturer. For tax purposes petitioner's purchases have been found to "constitute an integral part of its manufacturing business" by both the Tax Court and the Court of Appeals, and on essentially factual questions the findings of two courts should not ordinarily be disturbed. Comstock v. Group of Investors, 335 U.S. 211, 214.

Petitioner also makes much of the conclusion by both the Tax Court and the Court of Appeals that its transactions did not constitute "true hedging." It is true that Corn Products did not secure complete protection from its market operations. Under its sales policy petitioner could not guard against a fall in prices. It is clear, however, that petitioner feared the possibility of a price rise more than that of a price decline. It therefore purchased partial insurance against its principal risk, and hoped to retain sufficient flexibility to avoid serious losses on a declining market.

Nor can we find support for petitioner's contention that hedging is not within the exclusions of [§1221]. Admittedly, petitioner's corn futures do not come within the literal language of the exclusions set out in that section. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision of [§1221] must not be so broadly applied as to defeat rather than further the purpose of Congress. Burnet v. Harmel, 287 U.S. 103, 108. Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by [§1221] applies to transactions in property which are not the normal source of business income. It was intended "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." Burnet v. Harmel, 287 U.S., at 106. Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose. This Court has always construed narrowly the term "capital assets" in [§1221]. See Hort v. Commissioner, 313 U.S. 28, 31; Kieselbach v. Commissioner, 317 U.S. 399, 403.

The problem of the appropriate tax treatment of hedging transactions first arose under the 1934 Tax Code revision. Thereafter the Treasury issued G.C.M. 17322, supra, distinguishing speculative transactions in commodity futures from hedging transactions. It held that hedging transactions were essentially to be regarded as insurance rather than a dealing in capital assets and that gains and losses therefrom were ordinary business gains and losses. The interpretation outlined in this memorandum has been consistently followed by the courts as well as by the Commissioner. While it is true that this Court has not passed on its validity, it has been well recognized for 20 years; and Congress has made no change in it though the Code has been re-enacted on three subsequent occasions. This bespeaks congressional approval. Helvering v. Winmill, 305 U.S. 79, 83. Furthermore, Congress has since specifically recognized the hedging exception here under consideration in the short-sale rule of §1233(a) of the 1954 Code.[3]

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[3] Section 1233(a) provides that gain or loss from "the short sale of property, other than a hedging transaction in commodity futures," shall be treated as gain or loss from the sale of a capital asset to the extent "that the property, including a commodity future, used to close the short sale constitutes a capital asset in the hands of a taxpayer." The legislative history recognizes explicitly the hedging exception. H.R. Rep. No. 1337, 83d Cong., 2d Sess., p. A278; S. Rep. No

We believe that the statute clearly refutes the contention of Corn Products. Moreover, it is significant to note that practical considerations lead to the same conclusion. To hold otherwise would permit those engaged in hedging transactions to transmute ordinary income into capital gain at will. The hedger may either sell the future and purchase in the spot market or take delivery under the future contract itself. But if a sale of the future created a capital transaction while delivery of the commodity under the same future did not, a loophole in the statute would be created and the purpose of Congress frustrated.

The judgment is affirmed.

MR. JUSTICE HARLAN took no part in the consideration or decision of this case.

NOTE

1. *Scope of Corn Products doctrine.* In United States v. Rogers, 286 F.2d 277 (6th Cir. 1961), a taxpayer who was in the livestock business on a large scale claimed an ordinary loss on his transactions in commodity futures on the ground that he purchased commodity futures in an effort to protect himself against losses in the livestock business, rather than for investment or speculation. The court held that the transactions produced capital losses, however, because there was not a close enough link between price movements in his regular business and those of the commodities on which the losses were incurred. One judge dissented, arguing that the taxpayer's practice of selling commodity futures short would produce a gain in the event of an economic decline, and that this gain would offset credit losses that might result from the impact of the same economic decline on his livestock customers. See also Staple Gin Co. v. United States, 164 F. Supp. 919 (S.D. Tex. 1958), another case in which the court thought that the taxpayer had failed to establish a sufficient link between price fluctuations in commodity futures and the fortunes of his business to bring the *Corn Products* doctrine into play.

If an American manufacturer of textiles fears the competition of foreign-made goods and buys the stock of a foreign competitor in the hope that a loss incurred in his domestic business operations will be offset by an increase in the value of the foreign stock, will his profit on a sale of the stock be taxable as ordinary income under the *Corn Products* doctrine? Does *Corn Products* require the profit realized on the sale of the stock of a subsidiary corporation to be reported as ordinary income by the parent, if the subsidiary's business is related to the parent's (e.g., if the subsidiary is a sales or export agency of the parent)? If a taxpayer buys some of his employer's stock or bonds to strengthen his position as an employee, would his profit or loss on a sale of the securities be treated as ordinary income or loss? See Trent v. Commissioner, 291 F.2d 669 (2d Cir. 1961), and consider the relevance of the *Whipple* case, supra page 285.

The taxpayer in duPont & Co. v. United States, 288 F.2d 904 (Ct. Cl. 1961), sold compressed gas in heavy steel cylinders, requiring its customers to make a deposit in excess of the container's cost in order to insure their return. When customers failed to return the containers at the end of a three-year period, the taxpayer reported the profit on the forfeited deposits as income. The court held that the profit was capital gain, despite the *Corn Products* case:

> The determining factor is the purpose for which the property was held at the time of its acquisition and during its period of use; the nature of the commodity, its weight, its practically indestructible quality and the circumstances surrounding its use and disposition. In the light of these undisputed facts, the proceeds from the disposition of the unreturned cylinders should be treated as capital gains rather than as ordinary income. [288 F.2d at 909.]

2. *Gambling transactions.* In United States v. New York Coffee & Sugar Exchange, an antitrust case cited in *Corn Products,* the Supreme Court said that traders in com-

1622, 83d Cong., 2d Sess., p. 437: "Under existing law bona fide hedging transactions do not result in capital gains or losses. This result is based upon case law and regulations. To continue this result hedging transactions in commodity futures have been specifically excepted from the operation of this subsection."

modity futures fall into three classes: businessmen who are hedging against loss in their regular businesses; "legitimate capitalists," purchasing or selling with a view to profit based "on the law of supply and demand"; and "gamblers or irresponsible speculators who buy or sell as upon the turn of a card." If a taxpayer plays the commodity or stock market as he would the ponies, should the term "capital assets" be construed narrowly as to him on the ground that Congress could not have wished to encourage such transactions? If so, are the gambler's gains and losses to be treated as ordinary — or should this depend on whether he has more gains than losses — or is he an outlaw whose gains are taxable as ordinary income but whose losses are deductible only as capital losses? Does §165(d), permitting losses from wagering transactions to be deducted only to the extent of gains from such transactions, have any relevance in this connection?

3. *References.* Freeman, Is There a New Concept of a Business Asset, 36 Taxes 110 (1958); Note, Judicial Treatment of "Capital" Assets Acquired for Business: The New Criterion, 65 Yale L.J. 401 (1956).

COMMISSIONER v. BAGLEY & SEWALL CO.

221 F.2d 944 (2d Cir. 1955)

Before FRANK and MEDINA, Circuit Judges, and BRENNAN, District Judge.

BRENNAN, District Judge.

Whether or not the loss incurred in the posting of U.S. Government bonds as security for the performance of a contract is a capital loss or a business expense is the question posed on this appeal.

A background of essential facts were submitted by stipulation to the Tax Court. The Bagley & Sewall Co. (hereinafter referred to as the taxpayer), is a New York corporation engaged in the manufacture and sale of paper making machinery. In 1946 the taxpayer entered into a contract with a corporation acting in behalf of the Government of Finland for the manufacture and delivery of two paper making machines at a cost of approximately $1,800,000. Payments were to be made periodically during the progress of manufacture. The Government of Finland required that U.S. 2½% Government bonds be deposited with a New York financial institution as security for the performance of the contract and in accordance with an agreement which provided for the return of the bonds to Bagley & Sewall upon receipt of the last payment due under the contract. The above provisions were incorporated in and made a part of the contract. The taxpayer did not have or own the required bonds and in order to carry out the provisions of the contract, U.S. Government bonds in a total face value of $800,000 were purchased by the taxpayer with moneys borrowed for that purpose and same were deposited as required by the contract, the total cost of same being $820,062.50. The interest earned upon the bonds during the period that they were held in escrow was reported as income received by the taxpayer. In accordance with the terms of the contract, the bonds were released in two lots, one of $400,000 face value on Sept. 7, 1948 and one of $400,000 face value on Sept. 22, 1948. The bonds were sold by the taxpayer in each instance a few days after their release, resulting in a loss of approximately $15,000 which the taxpayer claimed, in its tax return for 1948, as an ordinary and necessary business expense. During the period that the bonds were held in escrow and until they were sold, they were carried in the general ledger of the taxpayer in an account entitled "U.S. Gov't. Bonds" and on its balance sheet of Dec. 31, 1946 and Dec. 31, 1947, the bonds were shown under the caption "U.S. Gov't. Bonds."

Upon re-audit, the Commissioner of Internal Revenue determined a deficiency in the taxpayer's 1948 return on the ground that the above loss was a capital loss under [§1221]. The matter came on before the Tax Court and after making minor adjustments, which are not here in dispute, the Tax Court found in effect

in accordance with the claim of the taxpayer that the sale of the bonds was of assets held for sale in the ordinary course of petitioner's business and the loss was deductible as an ordinary and reasonable business expense.

The findings made are substantially as outlined above with the following additions . . . that the taxpayer was not in the business of buying and selling securities, that its available cash reserve was necessary for working capital, that it is clear that no investment in U.S. bonds was intended by the petitioner, they were acquired solely to carry out a condition imposed by the contract. It was concluded that the purchase and sale of these bonds was merely an incident in the carrying on by the petitioner of its regular business of manufacturing and selling paper making machines. The Tax Court relied upon the decisions in Western Wine & Liquor Co., 18 T.C. 1090 and Charles A. Clark, 19 T.C. 48 and distinguished the case of Exposition Souvenir Corp. v. Commissioner, 2 Cir., 163 F.2d 283. This appeal followed.

Concisely stated, the contention by the Commissioner is that the bonds constituted capital assets, as the term is defined in [§1221]. . . .

The difficulty with the Commissioner's contention is that in effect he urges that the bond transaction should be considered independently of the contract of which it is a definite part. . . .

In Exposition Souvenir Corp. v. Commissioner, 2 Cir., 163 F.2d 283, the taxpayer was required to make an investment, related to, but not a part of the concession contract. This is not the situation here. The contract represents a complete business transaction, security of performance alone, not investment was required. The cost of procuring that security cannot be distinguished from ordinary premium expense of a surety company bond which is a usual item of contractor's costs. The *Exposition* case may be further distinguished by the fact that the debentures were treated as investments in the taxpayer's books and tax returns and in that case the Tax Court made a finding that the debentures were not held for sale in the ordinary course of business. There is no such treatment of this transaction in this taxpayer's tax return and no such finding. It is implicit that the Tax Court found that the bonds here were held for sale to purchasers as soon as released from escrow and available for sale. In the *Exposition* case, an investment was intended and the taxpayer relied upon the motive for the investment for relief. Here there is a clear finding that no investment was intended. The taxpayer's lack of surplus capital, the interest return of the bonds, the interest obligation of the loan and the almost immediate sale of the bonds when available make such a finding imperative. The finding here in this respect is similar to that made in Gilbert v. Commissioner, 1 Cir., 56 F.2d 361.

In brief, it is urged that the all inclusive language of [§1221] requires that, since the bonds are "property," they must be treated as capital assets unless exempted by the specific language of the Section. The argument carries with it the necessary conclusion that the circumstances of the transaction, its factual background, the necessities of the business involved and the intentions of taxpayer are of no importance except in determining whether the bonds are exempted under the Section. We are not persuaded that [§162(a)] is so completely subordinate to [§1221] and we find no authority which goes so far.

"Whether an expenditure is directly related to a business and whether it is ordinary and necessary are doubtless pure questions of fact in most instances." Commissioner v. Heininger, 320 U.S. 467, at 475. The purchase of stock in order to terminate an agency contract was held to be business expense. Helvering v. Community Bond & Mortgage Corporation, 2 Cir., 74 F.2d 727. The purchase of stock in a non-profit corporation to aid business was held to be a business expense. Commissioner v. The Hub, 4 Cir., 68 F.2d 349. The purchase of stock

of a liquor corporation in order to purchase liquor therefrom was held to be business expense. Hogg v. Allen, D.C., 105 F. Supp. 12, affirmed, Edwards v. Hogg, 5 Cir., 214 F.2d 640, 644. We find similar holdings by the Tax Court especially the two cases [*Western Wine* and *Clark*] relied upon by that Court and referred to above. The above authorities are cited here not to show that we necesarily agree with the conclusions therein but as an indication that business expense, [§162(a)], has been many times determined by business necessity without a specific consideration of [§1221]. . . .

The decision is affirmed.

FRANK, Circuit Judge (dissenting).

[After arguing that under §1221, all property constitutes "capital assets" unless explicitly excluded from that category by one of the subsections of §1221 and that "a court, facing such explicit statutory exceptions, has no power to invent another by recourse to other general statutory provisions," such as §162(a) or §165(a) "which do not refer to [§1221] and to which [§1221] does not refer," Judge Frank went on to discuss the cases relied upon by the majority.]

In Exposition Souvenir Corp. v. Commissioner, 2 Cir., 163 F.2d 283, the taxpayer, a concessionaire, purchased debenture bonds, of New York World's Fair 1939, Inc., as required by a contract in which the Fair awarded concession rights to the taxpayer corporation, held the debentures until six months after the close of the Fair, and then sold them at a net loss. The taxpayer urged, in the alternative, that the debentures were held for sale in the ordinary course of business or that the loss constituted an ordinary and necessary business expense deductible under [§162(a)]. The Tax Court ruled against both contentions and this court affirmed. The loss in that case, as in the case at bar, was a business expense, in that the concessionaire would probably not have purchased World's Fair debentures except to secure the concession. So here, taxpayer, in all probability, would not have purchased government bonds but for the expectation of contracting with the Finnish government. The bonds in both cases were capital assets, and did not lose that status because their purchasers were not primarily motivated by hopes of interest payments or a rise in their market value. In the earlier case of Helvering v. Community Bond & Mortgage Corporation, 2 Cir., 74 F.2d 727, per Manton, J., the taxpayer, in order to extinguish a troublesome agency contract, bought up the capital stock of the company with which it had contracted, reissued the stock to dummy stockholders, and promptly voted cancellation of the agency contract and the dissolution of the company. This court allowed the cost of the capital stock to be deducted as an ordinary and necessary expense of doing business. The question was not raised whether the loss was a capital loss. Without discussion of that question, the court treated the case just as if the taxpayer had directly paid money for cancellation of an exclusive-agency contract. Such a decision cannot serve as a precedent here. See Webster v. Fall, 266 U.S. 507, 511: "Questions which merely lurk in the record, neither brought to the attention of the court nor ruled upon, are not to be considered as having been so decided as to constitute precedents." . . .

I turn to cited cases decided in other circuits: In Commissioner v. The Hub, 4 Cir., 68 F.2d 349, 350, the taxpayer, a Wheeling, West Virginia, clothier, joined with other Wheeling retailers in organizing the Ohio Valley Industrial Corporation. The purpose of the corporation was to arrest the economic decline then experienced in Wheeling, by planning for and assisting in the settlement of new industry in the Wheeling area. Taxpayer's subscriptions to the capital of the corporation were permitted to be deducted as a business expense. In that case, however, the stock of the corporation, as distinguished from the government bonds in the instant case or from the Fair bonds in *Exposition Souvenir*, could not

be regarded as an investment. The Ohio Valley Industrial Corporation was a non-profit corporation, exempt from state and local taxes. The certificate of incorporation, after declaring that " 'This Corporation is not organized for personal gain, but only as a civic-undertaking,' " specifically provided that " 'there shall never be any dividends declared from profits, and all profits accruing shall be placed in a surplus fund for the objects and purposes of the Corporation.' " In those unusual circumstances, the court did not consider the stock purchase a purchase of capital assets.

In Edwards v. Hogg, 5 Cir., 214 F.2d 640, the taxpayer, engaged in the business of selling liquor, purchased all the shares of stock of a distilling company for the sole purpose of obtaining the liquor owned by the distilling company, and which the taxpayer intended to sell to its own customers in the ordinary course of its business. Looking through the distilling company to its assets, it was apparent that the purchase of that company's stock was but a means of acquiring the liquor which was then in short supply, i.e., obtaining the liquor was taxpayer's essential purpose. The liquor itself was property of a kind which came within one of the exceptions explicitly stated in [§1221]. Gilbert v. Commissioner, 1 Cir., 56 F.2d 361, presents a case where a building contractor received, as compensation, shares of stock in the company for which the building was erected. As found by the trial court, he accepted them in lieu of cash and intended to convert them into cash as soon as possible (a practice not uncommon among engineering and contracting firms of that day). The court found that, in those circumstances, the stock was property held by the taxpayer primarily for sale in the course of his trade or business. I think a better rationale of that decision would be that, whenever a taxpayer receives property as compensation, the situation is to be regarded as if he had received cash and had then invested it in that property; the cash value of the property is therefore part of his ordinary gross income and taxable as such. Section [1221] has no application to a case of that sort. If, however, such a taxpayer retains the property, then it is a "capital asset" — i.e., an investment in that property — and [§1221] applies to its subsequent disposition.

There is no need to consider here the problem which would arise if a taxpayer, as part of a contract, obligated himself to buy some securities, from the other party to the contract, at a price above the market price. For that was not the case here. Indeed, the contract here did not require taxpayer to buy any government bonds but merely to put such bonds in escrow, a requirement which could have been met without a purchase of bonds, if the taxpayer had already owned a sufficient amount of them. . . .

NOTE

1. *Scope of Bagley & Sewall Co. case.* If the taxpayer had retained the bonds after they were released from escrow and sold them some years later, would the result be different? Would this depend upon whether they were held solely in the hope of recouping the decline in value that had occurred during the escrow period? Should the gain or loss realized on selling the bonds be allocated between the escrow period and the post-escrow period, with the gain or loss attributable to the former period being treated as business income or loss and the post-escrow amount treated as capital gain or loss? See Gulftax Drug Co. v. Commissioner, 29 T.C. 118 (1957), aff'd per curiam, 261 F.2d 238 (5th Cir. 1958) (property acquired for business use but converted thereafter to an investment purpose; held, capital loss); but compare the treatment of losses on the disposition of property acquired for personal use but subsequently dedicated to a business purpose, supra page 245.

If the agreement in *Bagley & Sewall* had required the taxpayer to keep marketable securities with a value of at least $800,000 on deposit at all times, but permitted securities

to be sold on the taxpayer's order so long as securities of sufficient value were substituted, how would profits and losses realized on such sales be treated?

2. *Stock acquired to insure a source of supplies.* Taxpayers have frequently been allowed an ordinary loss deduction on a sale of stock acquired to insure a source of supplies used in their business. See, for example, Booth Newspapers, Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962) (stock of paper manufacturer acquired by newspaper publisher to insure source of newsprint during period of acute shortage); Tulane Hardwood Lumber Co. v. Commissioner, 24 T.C. 1146 (1955) (debentures of plywood manufacturer bought by lumber dealer). Judging from the reported cases, these transactions more often produce a loss than a gain. It is possible, of course, that taxpayers who report capital gains do not usually encounter any resistance from the Internal Revenue Service because profits on the sale of stock are ordinarily taxable as capital gain and there is no formal way in which the taxpayer's business purpose in acquiring the stock would come to the Service's attention. In Mansfield Journal Co. v. Commissioner, 274 F.2d 284 (6th Cir. 1960), however, the court held that a newspaper company's profit on the sale of a long-term contract for the purchase of newsprint was ordinary income under the *Corn Products* rationale; and the same result would seem proper if the taxpayer had sold the stock of the supplier.

See also Hagan v. United States, 221 F. Supp. 248 (W.D. Ark. 1963) (salesman purchased stock of a customer in order to protect his source of commissions; held, loss on worthlessness deductible from ordinary income).

2. *Substitute for Ordinary Income*

HORT v. COMMISSIONER

313 U.S. 28 (1941)

Mr. Justice Murphy delivered the opinion of the Court.

We must determine whether the amount petitioner received as consideration for cancellation of a lease of realty in New York City was ordinary gross income as defined in [§61(a)], and whether, in any event, petitioner sustained a loss through cancellation of the lease which is recognized in [§165(a)].

Petitioner acquired the property, a lot and ten-story office building, by devise from his father in 1928. At the time he became owner, the premises were leased to a firm which had sublet the main floor to the Irving Trust Co. In 1927, five years before the head lease expired, the Irving Trust Co. and petitioner's father executed a contract in which the latter agreed to lease the main floor and basement to the former for a term of fifteen years at an annual rental of $25,000, the term to commence at the expiration of the head lease.

In 1933, the Irving Trust Co. found it unprofitable to maintain a branch in petitioner's building. After some negotiations, petitioner and the Trust Co. agreed to cancel the lease in consideration of a payment to petitioner of $140,000. Petitioner did not include this amount in gross income in his income tax return for 1933. On the contrary, he reported a loss of $21,494.75 on the theory that the amount he received as consideration for the cancellation was $21,494.75 less than the difference between the present value of the unmatured rental payments and the fair rental value of the main floor and basement for the unexpired term of the lease. He did not deduct this figure, however, because he reported other losses in excess of gross income.

The Commissioner included the entire $140,000 in gross income, disallowed the asserted loss, made certain other adjustments not material here, and assessed a deficiency. The Board of Tax Appeals affirmed. 39 B.T.A. 922. The Circuit Court of Appeals affirmed per curiam on the authority of Warren Service Corp. v. Commissioner, 110 F.2d 723. 112 F.2d 167. Because of conflict with Commissioner v. Langwell Real Estate Corp., 47 F.2d 841, we granted certiorari limited to the

that Congress intended to allow petitioner to reduce ordinary income actually received and reported by the amount of income he failed to realize. . . . We may assume that petitioner was injured insofar as the cancellation of the lease affected the value of the realty. But that would become a deductible loss only when its extent had been fixed by a closed transaction. Regulations [§1.165-1(b)]; United States v. White Dental Mfg. Co., 274 U.S. 398.

The judgment of the Circuit Court of Appeals is affirmed.

NOTE

1. *Significance of §61(a).* Mr. Justice Murphy suggests in *Hort* that the amount received by the taxpayer was taxable as ordinary income partly because it was a substitute for rental payments that are "expressly characterized as gross income" by what is now §61(a)(5). Does this imply that the term "gross income" does not embrace capital gains as well as ordinary income? Are stock market profits to be denied capital gain treatment because §61(a)(3) expressly characterizes "gains derived from dealings in property" as gross income?

2. *The "substitute for ordinary income" theory.* Assume that Smith owns a parcel of vacant land that can be most profitably used, for the foreseeable future, as a parking lot. Jones offers to take the property on a 99-year lease for a rental of $5000 per year or to buy it outright for $100,000; both Jones and Smith think that these alternative proposals are of equal value because $100,000 invested in an annuity would yield, assuming a 5 per cent interest factor, about $5000 per year for 99 years and the residual value of the land at the end of 99 years can be ignored; they also think that if Smith were to go into the parking lot business himself he would earn about $5000 per year above his expenses (including reasonable compensation for his own services). If Smith decides to sell the land to Jones, would his profit constitute ordinary income on the ground that it is a substitute either for the rent that he might otherwise have obtained by leasing the property to Jones or for the investment return that he might have realized by operating it himself? See Samuelson, Economics 647 (5th ed. 1961): "What exactly is the formula for the capitalized market value of *any* asset? . . . Under absolute certainty, every asset will be capitalized by the price bids of buyers and sellers in the market place at the present discounted value of all its future net receipts." See also Bonbright, Valuation of Property 216-266 (1937 ed.).

In United States v. Dresser Industries, Inc., 324 F.2d 56, 58-59 (5th Cir. 1963), involving an agreement under which the taxpayer authorized another company to use a patent for $500,000, to be paid out of the fees received by the latter company for using the patent in work for third parties, the court said:

> The government did not, below, raise the first point, that is, that the gain is anticipated future income, and cannot raise it here on appeal for the first time. . . . But we feel that the broad assertion made that, in any case where the purchase price includes anticipated income there can be no capital gains treatment, must be answered. . . . As a legal or economic position, this cannot be so. The only commercial value of any property is the present worth of future earnings or usefulness. If the expectation of earnings of stock rises, the market value of the stock may rise; at least a part of this increase in price is attributable to the expectation of increased income. The value of a vending machine, as metal and plastic, is almost nil; its value arises from the fact that it will produce income.
>
> At common law, the right to receive income from land was ownership of the land. Lord Coke said: "If a man seized of land in fee by his deed granteth to another the profits of these lands, to have and to hold to him and his heirs, and maketh livery secundum forman chartae, the whole land itself doth pass. *For what is land but the profits thereof?*" Co. Lit. 45. [Emphasis added.]
>
> There is, in law and fact, a vast difference between the present sale of the future right to *earn* income and the present sale of the future right to *earned* income. If an asset will not in the future be useful, or capable of earning income, it is worthless in the business world.

question whether, "in computing net gain or loss for income tax purposes, a taxpayer [can] offset the value of the lease canceled against the consideration received by him for the cancellation." 311 U.S. 641.

Petitioner apparently contends that the amount received for cancellation of the lease was capital rather than ordinary income and that it was therefore subject to [the provisions of the Code] which govern capital gains and losses. Further, he argues that even if that amount must be reported as ordinary gross income he sustained a loss which [§165(a)] authorizes him to deduct. We cannot agree.

The amount received by petitioner for cancellation of the lease must be included in his gross income in its entirety. . . . [§61(a)] reached the rent paid prior to cancellation just as it would have embraced subsequent payments if the lease had never been canceled. It would have included a prepayment of the discounted value of unmatured rental payments whether received at the inception of the lease or at any time thereafter. Similarly, it would have extended to the proceeds of a suit to recover damages had the Irving Trust Co. breached the lease instead of concluding a settlement. Compare United States v. Safety Car Heating Co., 297 U.S. 88; Burnet v. Sanford, 282 U.S. 359. That the amount petitioner received resulted from negotiations ending in cancellation of the lease rather than from a suit to enforce it cannot alter the fact that basically the payment was merely a substitute for the rent reserved in the lease. So far as the application of [§61(a)] is concerned, it is immaterial that petitioner chose to accept an amount less than the strict present value of the unmatured rental payments rather than to engage in litigation, possibly uncertain and expensive.

The consideration received for cancellation of the lease was not a return of capital. We assume that the lease was "property," whatever that signifies abstractly. Presumably the bond in Helvering v. Horst and the lease in Helvering v. Bruun were also "property," but the interest coupon in *Horst* and the building in *Bruun* nevertheless were held to constitute items of gross income. Simply because the lease was "property" the amount received for its cancellation was not a return of capital, quite apart from the fact that "property" and "capital" are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments which [§61(a)(5)] expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that for some purposes the contract creating the right to such payments may be treated as "property" or "capital."

For the same reasons, that amount was not a return of capital because petitioner acquired the lease as an incident of the realty devised to him by his father. Theoretically, it might have been possible in such a case to value realty and lease separately and to label each a capital asset. Compare Maass v. Higgins, 312 U.S. 443; Appeal of Farmer, 1 B.T.A. 711. But that would not have converted into capital the amount petitioner received from the Trust Co., since [§102(b)(1)] would have required him to include in gross income the rent derived from the property, and that section, like [§61(a)], does not distinguish rental payments and a payment which is clearly a substitute for rental payments.

We conclude that petitioner must report as gross income the entire amount received for cancellation of the lease, without regard to the claimed disparity between that amount and the difference between the present value of the unmatured rental payments and the fair rental value of the property for the unexpired period of the lease. The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Undoubtedly it diminished the amount of gross income petitioner expected to realize, but to that extent he was relieved of the duty to pay income tax. Nothing in [§165(a)] indicates

> We conclude, therefore, that the sale was not merely the present sale of the right to earned income, to be paid in the future. Taxpayer had an asset, a right, a property which would produce income. The fact that the income which *could* be earned would be ordinary income is immaterial; such would be true of the sale of all income-producing property.

See also the concurring opinion of Judge John R. Brown at 61-62:

> Running through several of our prior opinions is the asserted concept that capital gains versus ordinary income is to be determined by the status of current earnings were the asset to have remained in the hands of the transferor. On this approach it is reasoned that if the current income would have been taxable ordinary income, then the sales price which represents the substitute for such future earnings is likewise taxable ordinary income.
>
> I think this is both bad economics and faulty law. A person acquires property for one of two, or both reasons. The first is to receive earnings, i.e., income. The other is to hold the property for appreciation resulting from long or short range economic conditions, inflation or the like. Normally, of course, the predominant reason is to acquire the earning capacity represented by the earnings which the property will generate.
>
> Hence it is that among those who trade in corporate securities on established national exchanges or over-the-counter markets, there are recognized rules of thumb by which the present value, hence market price, is determined for a given stock. The same is true in the contemporary, frequent practice of large-scale corporate acquisitions by one corporation of the stock or assets of another corporation. Value — market or sales price — is determined by capitalizing earnings. Whether the formula is the conservative one of 6 or 7 times earnings, or something less, or one considerably more speculative, what the buyer offers is his estimate of the present, discounted value of the future earnings of the assets or enterprise.
>
> But although this sales price is determined by future earnings, and to the seller it takes the place of what he would have received had he continued his ownership, under no stretch of the imagination is it "ordinary income" either in the business world or in the sometimes more weird, tax world. Were this so, then every such sale for a price in excess of cost would entail this analysis and this tax consequence.

3. *"Premium value" of inherited lease.* The father of the taxpayer in *Hort* died in 1928, one year after the lease was executed, and it may not have had a premium value as of that time. By 1933, however, the lease was a valuable asset, as is evidenced by the lessee's willingness to pay $140,000 to be relieved of its obligations. If the taxpayer's father had died in 1932 or in early 1933, would the taxpayer have been entitled to a basis for the lease (separate from his basis for the underlying land and building) equal to its value on the date of his father's death? If so, could this basis have been (a) amortized against the rents paid by the tenant, (b) taken into account in computing gain or loss if the taxpayer sold the lease, or (c) offset against the $140,000 received on cancellation of the lease? See World Publishing Co. v. Commissioner, supra page 306; Commissioner v. Moore, 207 F.2d 265 (9th Cir. 1953), noted in 67 Harv. L. Rev. 894 (1954).

McALLISTER v. COMMISSIONER

157 F.2d 235 (2d Cir. 1946), cert. denied, 330 U.S. 826 (1947)

Before SWAN, CLARK, and FRANK, Circuit Judges.

CLARK, Circuit Judge.

This petition for review presents the question whether the sum of $55,000 received by petitioner on "transfer" or "surrender" of her life interest in a trust to the remainderman constitutes gross income under [§61(a)], or receipts from the sale of capital assets as defined in [§1221]. As we shall see, some significance seemingly is attached to a choice between the two words set in quotation marks as a description of the transaction. Petitioner contends that the life estate was a capi-

tal asset, the transfer of which resulted in a deductible capital loss, leaving her with no taxable income for the year. A majority of the Tax Court agreed with the Commissioner that the receipt in question was merely an advance payment of income, while four judges dissented, Judges Opper and Disney writing the opposing opinions. 5 T.C. 714.

The will of Richard McAllister established a trust fund of $100,000, the income of which was to be paid to his son John McAllister for life and, on the latter's death without children, to John's wife, the petitioner herein. On her death, the trust was to terminate, the residue going to the testator's wife and his son Richard. The testator died in 1926, his widow in 1935, and John in 1937. Except for stock in the R. McAllister corporation, not immediately salable at a fair price, John left assets insufficient to meet his debts; and in order to obtain immediate funds and to terminate extended family litigation according to an agreed plan, petitioner brought suit in the Court of Chancery of New Jersey to end the trust. The parties then agreed upon, and the court in its final decree ordered, a settlement by which the remainderman Richard, in addition to taking over the stock for $50,000, was to pay petitioner $55,000, with accumulated income and interest to the date of payment, in consideration of her release of all interest in the trust and consent to its termination and cancellation. Receiving payment on July 19, 1940, petitioner, in accordance with the court order, executed a release, providing:

> I do further consent and agree that my estate in the aforesaid trust, created under the third paragraph of the . . . will . . . shall be and the same is hereby terminated absolutely, and I do decline to accept further any benefits therefrom or interest therein.

For the year 1940, she reported a capital loss on the transaction of $8,790.20, the difference between the amount received and the value of the estate computed under I.T. 2076.* The Commissioner disallowed the loss and made the deficiency assessment which was upheld by the majority below.

The issue, as stated by the Tax Court and presented by the parties, reduces itself to the question whether the case is within the rule of Blair v. Commissioner [supra p. 350], or that of Hort v. Commissioner [supra p. 499]. In the *Blair* case, the life beneficiary of a trust assigned to his children specified sums to be paid each year for the duration of the estate. The Supreme Court held that each transfer was the assignment of a property right in the trust and that, since the tax liability attached to ownership of the property, the assignee, and not the assignor, was liable for the income taxes in the years in question. The continued authority of the case was recognized in Helvering v. Horst [supra p. 352], although a majority of the Court thought it not applicable on the facts, and in Harrison v. Schaffner [supra p. 356], where the Court very properly distinguished it from the situation where an assignor transferred a portion of his income for a single year. We think that its reasoning and conclusion support the taxpayer's position here. It has been relied upon by other cases cited below which we find indistinguishable from the present case.

Petitioner's right to income for life from the trust estate was a right in the estate itself. Had she held a fee interest, the assignment would unquestionably have been regarded as the transfer of a capital asset; we see no reason why a different result should follow the transfer of the lesser, but still substantial, life interest. As the Court pointed out in the *Blair* case, the life tenant was entitled to enforce the trust, to enjoin a breach of trust, and to obtain redress in case of breach. The proceedings in the state chancery court completely divested her of these rights and of any possible control over the property. The case is therefore distinguishable from that of Hort v. Commissioner, supra, where a landlord for a consideration

* For this ruling see editor's note, infra page 507. — Ed.

cancelled a lease for a term of years, having still some nine years to run. There the taxpayer surrendered his contractual right to the future yearly payments in return for an immediate payment of a lump sum. The statute expressly taxed income derived from rent [§61(a)(5)]; and the consideration received was held a substitute for the rent as it fell due. It was therefore taxed as income.

What we regard as the precise question here presented has been determined in the taxpayer's favor on the authority of the *Blair* case by the Eighth Circuit in Bell's Estate v. Commissioner, 8 Cir., 137 F.2d 454, reversing 46 B.T.A. 484. . . .

The Tax Court and the government have attempted to distinguish both the *Bell* and the *Blair* cases on grounds which seem to us to lack either substance or reality. The principal ground seems to be the form the transaction assumed between the parties. Thus the Court says that petitioner received the payment for "surrendering" her rights to income payments, and "she did not assign her interest in the trust, as did petitioners in the *Bell* case." But what is this more than a distinction in words? Both were cases where at the conclusion of the transaction the remaindermen had the entire estate and the life tenants had a substantial sum of money. There surely cannot be that efficacy in lawyers' jargon that termination or cancellation or surrender carries some peculiar significance vastly penalizing laymen whose counsel have chanced to use them. And the fact that the whole affair was embodied in a court decree can add nothing more than a seal of legal validity to it. What was practically accomplished remained the same. And that here, as in the *Bell* case, there was a "surrender" to the remainderman, rather than a "transfer" to third persons as in the *Blair* case, does not change the essentially dispositive nature of the transaction so far as the former property owner is concerned.

Other suggestions seem equally dubious. Thus it is said that the transfer in the *Blair* case was without consideration. But it is hard to see how this affects either the fact or the validity of the transfer; if anything, the odds should favor the conveyance for a consideration — the income of which will yield taxes in the future. Naturally, since there were no capital gains or losses, the *Blair* case does not discuss them. (Actually it cites neither the gross income nor the capital assets statutes.) But its holding that the assignment leaves no taxable income with the assignor is just as potent here on the like point, even though we do have the further problem posited by the claim of a capital loss. And there was very definitely a consideration paid in the *Bell* case. Next it is urged that there could be no assignment because this was a spendthrift trust where the creator had forbidden assignment or anticipation by a beneficiary. (The form of prohibition here was an express command as to a vested equitable interest; there was no grant of discretionary power to the trustees to withhold income.) But the answer is that it was done by a series of transactions affirmed by the state court. That is, the trust provisions made passing of the interest somewhat more difficult, but not beyond the ingenuity of lawyers, when the parties were agreed. So in the *Blair* case the government argued that the trust was a spendthrift trust under Illinois law. Said the Court, 300 U.S. 5, 10:

> The point of the argument is that, the trust being of that character, the state law barred the voluntary alienation by the beneficiary of his interest. The state court held precisely the contrary. The ruling also determines the validity of the assignment by the beneficiary of parts of his interest. That question was necessarily presented and expressly decided.

Setting the bounds to the area of tax incidence involves the drawing of lines which may often be of an arbitrary nature. But they should not be more unreal

than the circumstances necessitate. Here the line of demarcation between the *Blair* and the *Hort* principles is obviously one of some difficulty to define explicitly or to establish in borderline cases. Doubtless all would agree that there is some distinction between selling a life estate in property and anticipating income for a few years in advance. It is the kind of distinction stressed in Harrison v. Schaffner, where the Court said:

> Nor are we troubled by the logical difficulties of drawing the line between a gift of an equitable interest in property for life effected by a gift for life of a share of the income of the trust and the gift of the income or a part of it for the period of a year as in this case.

The distinction seems logically and practically to turn upon anticipation of income payments over a reasonably short period of time and an out-and-out transfer of a substantial and durable property interest, such as a life estate at least is. See 57 Harv. L. Rev. 382; 54 Harv. L. Rev. 1405; 50 Yale L.J. 512, 515. Where the line should be finally placed we need not try to anticipate here. But we are clear that distinctions attempted on the basis of the various legal names given a transaction, rather than on its actual results between the parties, do not afford a sound basis for its delimitation. More rationally, to accept the respondent's contention we ought frankly to consider the *Blair* case as overruled, 50 Yale L.J. 512, 518, a position which, as we have seen, the Supreme Court itself has declined to take.

The parties are in conflict as to the valuation of the life estate; and we are returning the case to the Tax Court for computation, without, of course, assuming that there will necessarily be some tax.

Reversed and remanded.

FRANK, Circuit Judge (dissenting).

Taxpayer's father-in-law, by his will, created a trust by which taxpayer during her life was to receive the income from a fund of $100,000; the will provided that she was not to dispose of her interest or otherwise to anticipate the income. She joined with others interested in the trust to demolish it; in consideration of her doing so, she received a lump sum of $55,000. The question is whether, with respect to that $55,000, resulting from the frustration of the testator's purpose through the destruction of the trust, she is entitled to the exceptional advantages of the capital gains provisions.

We must, then, ascertain the intention of Congress expressed in those provisions — especially [§1221] — in the light of the language it employed and the policy there embodied, i.e., we must determine whether Congress intended that a taxpayer who receives income in those circumstances should come within that exception.

My colleagues avoid a direct discussion of that problem. Instead, they rely on Blair v. Commissioner, which they hold to be controlling. But the court in the *Blair* case had no occasion to, and did not, consider [§1221]; it considered solely the interpretation of [§61(a)]. There, the holder of a life interest, created by a trust, had made a gift for life of a share of the future income. The only question was whether thereafter the donor, notwithstanding the gift, should be regarded, under [§61(a)], as the recipient annually of that part of the income which was the subject of the gift and, consequently, should be taxed each year thereon. In other words, no capital gain or loss was involved, and the one issue was whether the donor or donee was annually taxable. The only conceivable ground for holding the donor liable was — as the court recognized in Helvering v. Horst and Harrison v. Schaffner — that which moved the Court in Helvering v. Clifford [supra p. 372], i.e., that, in terms of "non-material satisfactions" the donor had not, by the

gift, changed his position and, because of his continued "enjoyment of the economic benefit," must still be regarded, within [§61(a)], as receiving the income actually paid to the donee. . . .

The policy of the capital gains provisions is not in doubt: Congress believed that the exaction of income tax on the usual basis on gains resulting from dispositions of capital investments would undesirably deter such dispositions. To put it differently, Congress made an exception to [§61(a)], in order to give an incentive to the making of such transfers. Having regard to that purpose, the courts have been cautious in interpreting the clauses creating that exception. They have refused to regard as "capital" transactions for that purpose divers sorts of transfers of "property," especially those by which transferors have procured advance payments of future income.

Those cases and Hort v. Commissioner seem to me to render it somewhat doubtful whether any transfer of a life estate for a valuable consideration is within [§1221]. The consideration paid for such a transfer is a substitute for future payments which would be taxable as ordinary income, and resembles the advance payment of dividends, interest or salaries. I am, therefore, not at all sure that Bell's Estate v. Commissioner, 8 Cir., 137 F.2d 454, is correct (although, for reasons noted below, I think it is not apposite here). It may well be that, had Congress specifically thought of the problem, it would explicitly so have defined "capital assets" as to exclude such an interest. I do not say that Hort v. Commissioner conclusively fixes that interpretation, but it does so suggest.

It suggests far more strongly that we cannot reasonably extrapolate the language of [§1221] to include the transaction before us in the instant case. In the *Hort* case, the Supreme Court held that the "prepayment of the discounted value of unmatured rental payments" to a landlord on the cancellation of a lease constituted "ordinary income," coming within [§61(a)], and not within the capital gains clauses. The Court said, "Simply because the lease was 'property' the amount received for its cancellation was not a return of capital"; and it also said that

> it is immaterial that for some purposes the contract creating the right to such payments may be treated as "property" or "capital." . . . The cancellation of the lease involved nothing more than the relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises . . .

and it added that [§61(a)] "does not distinguish rental payments and a payment which is clearly a substitute for rental payments."

That ruling is indeed suggestive here. For here we have these facts: The creator of the trust did everything he could to keep the taxpayer from disposing of her life interest.[1] Aided by what my colleagues described as "the ingenuity of counsel," she succeeded in frustrating his effort to prevent such alienation, by joining with the other persons interested in the trust to "extinguish" and "cancel" it; the instruments she executed in that connection recited that the payment to her was "to represent the value of her life interest" and that the "settlement is

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1 His will and codicil contained the following provisions:

"I further direct that the income from the various trusts hereinabove created shall not be subject to any transfers, assignments or encumbrances, made or created by any of the respective beneficiaries, and shall not be subject to any suits, liens, judgments, attachments, or executions resulting from any debts or acts of any of the respective beneficiaries, nor shall the same be subject to any suits, actions or proceedings, of any kind, brought against any of them. . . .

"I will and direct that all the shares of principal and income by this my will given to or directed to be held for the use and benefit of the several and respective beneficiaries in the Trusts in this my will mentioned or set out shall not be in any way or manner subject or liable to their or either of their anticipation, sale, pledge, debts, contracts, engagements or liabilities, and not subject or liable to attachment or sequestration under any legal or equitable or other process."

based to a large extent upon her life expectancy." In that way, what the testator intended should be given to her only in instalments, she procured, in effect, in a lump sum payment.

I think it most unlikely that Congress intended by [§1221] to relieve such a taxpayer of the ordinary tax burdens, to supply an incentive for the demolition of such a trust. That the life tenant in the *Blair* case in somewhat similar manner avoided the intent of the trust's creator is, I think, of no moment; for that conduct was not relevant to the issue of Congressional purpose there before the Court, i.e., whether [§61(a)] made her taxable on the income subsequently paid her donee. But here the question is whether Congress meant that the exceptional benefits of [§1221] should be accorded a taxpayer who, in disposing of her life interest, circumvented the avowed purpose of the creator of the trust. I think not.

Perhaps Bell's Estate v. Commissioner is distinguishable from the instant case. For there the creator of the trust had not sought to prevent alienation of the life interests, and it is arguable that furtherance of sales of such interests falls within the intention of [§1221]. But, since that question is not present here, I think we should leave it unanswered.

For the foregoing reasons, I think the Tax Court's decision should be affirmed.

NOTE

1. *Is a life estate better dead than alive?* This case should be studied in conjunction with the rule of Irwin v. Gavit, and its statutory codification, supra page 145. Because of §102(b)(2) and §273, the life tenant is taxed on the entire income of the trust, without allowance for the fact that the rights which he inherited will decline in value during his lifetime and be obliterated by his death. But the Regulations provide that the life tenant has a basis for his interest in the trust, for purposes of computing gain or loss on a sale, even though under §273 no part of this basis can be amortized against his receipts if he retains his interest. Regs. §1.1014-5. If the life tenant sells his interest under a testamentary trust immediately after the testator's death, his basis under §1014 is the value of his life estate on the date of death. If he holds the interest for a period of time, however, it is not clear whether the date-of-death basis remains intact, Allen v. First National Bank & Trust Co., 157 F.2d 592 (5th Cir. 1946), cert. denied, 330 U.S. 828 (1947), or must be adjusted downward to reflect the reduction in value owing to the life tenant's greater age, see Regs. §1.1014-5, Example; I.T. 2067, III-2 C.B. 18, referred to by the court in the *McAllister* case. The taxpayer in *McAllister* followed the latter theory, and computed her basis by reference to her age when the life interest was sold in 1940, rather than using the value of the interest when acquired by inheritance in 1927. Use of the 1927 value would have increased her basis and, therefore, her loss.

Did the court hold that the entire proceeds of the sale was to be reported as capital gain? See the last paragraph of the opinion. Under the court's theory, could there have been a deductible loss, as the taxpayer reported?

If the *McAllister* case can be relied on, how can life tenants afford *not* to sell their interests? What practical obstacles stand in their way?

2. *Short-term transactions.* The taxpayer in the *McAllister* case was 35 when she sold her life estate, and her life expectancy was about 37 years. Would the court have reached the same result if she had been much older and had a life expectancy of only 5 or 10 years? See Rev. Rul. 55-38, discussed in paragraph 10 of the editor's note, supra page 380, for a possible analogy.

3. *Treatment of remainderman.* After the remainderman in *Bell's Estate* (followed by the court in the *McAllister* case) acquired the life tenant's interest, he sought to amortize his cost, over the life expectancy of the life tenant, against the income that he derived from the property. Rejecting the government's contention that the amount paid to acquire the life estate was a capital investment to be recovered only when the property itself was sold because there had been a "merger" of the life estate and the remainder, the Court of Appeals for the Seventh Circuit upheld the taxpayer's right to amortize his cost

currently, and the Internal Revenue Service has announced its acquiescence. Bell v. Harrison, 212 F.2d 253 (7th Cir. 1954); Rev. Rul. 62-132, 1962-2 C.B. 73 (acquiescence limited to transactions that are bona fide and not for tax avoidance).

4. *Reference.* Plumb, Tax Effects of Sales of Life Interests in Trusts: How to Eat Your Cake and Have It, 9 Tax L. Rev. 39 (1953).

COMMISSIONER v. LAKE

356 U.S. 260 (1958)

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

We have here, consolidated for argument, five cases involving an identical question of law. Four are from the Tax Court whose rulings may be found in 24 T.C. 1016 (the *Lake* case), 24 T.C. 818 (the *Fleming* case), 24 T.C. 1025 (the *Weed* case). (Its findings and opinion in the *Wrather* case are not officially reported.) Those four cases involved income tax deficiencies. The fifth, the *O'Connor* case, is a suit for a refund originating in the District Court. 143 F. Supp. 240. All five are from the same Court of Appeals, 241 F.2d 71, id., p. 65, id., p. 78, id., p. 84, id., p. 69. The cases are here on petitions for certiorari which we granted because of the public importance of the question presented. 353 U.S. 982.

The facts of the *Lake* case are closely similar to those in the *Wrather* and *O'Connor* cases. Lake is a corporation engaged in the business of producing oil and gas. It has a seven-eighths working interest[1] in two commercial oil and gas leases. In 1950 it was indebted to its president in the sum of $600,000 and in consideration of his cancellation of the debt assigned him an oil payment right in the amount of $600,000, plus an amount equal to interest at 3 percent a year on the unpaid balance remaining from month to month, payable out of 25 percent of the oil attributable to the taxpayer's working interest in the two leases. At the time of the assignment it could have been estimated with reasonable accuracy that the assigned oil payment right would pay out in three or more years. It did in fact pay out in a little over three years.

In its 1950 tax returns Lake reported the oil payment assignment as a sale of property producing a profit of $600,000 and taxable as a long-term capital gain . . . The Commissioner determined a deficiency, ruling that the purchase price (less deductions not material here) was taxable as ordinary income, subject to depletion. The *Wrather* case has some variations in its facts. In the *O'Connor* case the assignors of the oil payments owned royalty interests[2] rather than working interests. But these differences are not material to the question we have for decision.

The *Weed* case is different only because it involves sulphur rights, rather than oil rights. The taxpayer was the owner of a pooled overriding royalty in a deposit known as Boling Dome.[3] The royalty interest entitled the taxpayer to receive $0.00966133 per long ton of sulphur produced from Boling Dome, irre-

1 An oil and gas lease ordinarily conveys the entire mineral interest less any royalty interest retained by the lessor. The owner of the lease is said to own "the working interest" because he has the right to develop and produce the minerals.

In Anderson v. Helvering, 310 U.S. 404, we described an oil payment as "the right to a specific sum of money, payable out of a specified percentage of the oil, or the proceeds received from the sale of such oil, if, as and when produced." Id., at 410. A royalty interest is "a right to receive a specified percentage of all oil and gas produced" but, unlike the oil payment, is not limited to a specified sum of money. The royalty interest lasts during the entire term of the lease. Id., at 409.

2 See note 1, supra.

3 Boling Dome is a tract composed of various parcels of land. The owners of the royalty interests in sulphur produced from the separate parcels entered into a pooling agreement by which royalties from sulphur produced anywhere in Boling Dome were distributed pro rata among all the royalty interest holders. In that sense was the interest of each "pooled."

spective of the market price. Royalty payments were made each month, based on the previous month's production.

In 1947, the taxpayer, in order to obtain a sure source of funds to pay his individual income taxes, agreed with one Munro, his tax advisor, on a sulphur payment assignment. The taxpayer assigned to Munro a sulphur payment totaling $50,000 and consisting of 86.254514 percent of his pooled royalty interest, which represented the royalty interest on 6,000,000 long tons of the estimated remaining 21,000,000 long tons still in place. The purchase price was paid in three installments over a three-year period. Most of the purchase price was borrowed by Munro from a bank with the sulphur payment assignment as security. The assigned sulphur payment right paid out within 28 months. The amounts received by the taxpayer in 1948 and 1949 were returned by him as capital gains. The Commissioner determined that these amounts were taxable as ordinary income, subject to depletion.

The *Fleming* case is a bit more complicated and presents an additional question not in the other cases. Here oil payment assignments were made, not for cash but for real estate. Two transactions are involved. Fleming and others with whom he was associated made oil payment assignments, the rights and interests involved being held by them for productive use in their respective businesses of producing oil. Each oil payment was assigned for an interest in a ranch. Each was in an amount which represented the uncontested fair value of the undivided interest in the ranch received by the assignor, plus an amount equal to the interest per annum on the balance remaining unpaid from time to time. The other transaction consisted of an oil payment assignment by an owner of oil and gas leases, held for productive use in the assignor's business, for the fee simple title to business real estate. This oil payment assignment, like the ones mentioned above, was in the amount of the uncontested fair market value of the real estate received, plus interest on the unpaid balance remaining from time to time.

First, as to whether the proceeds were taxable as long term taxable gains . . . or as ordinary income subect to depletion. The Court of Appeals started from the premise, laid down in Texas decisions, see especially Tennant v. Dunn, 130 Tex. 285, 110 S.W.2d 53, that oil payments are interests in land. We too proceed on that basis; and yet we conclude that the consideration received for these oil payment rights (and the sulphur payment right) was taxable as ordinary income, subject to depletion.

The purpose of [the capital gains provisions] was "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." See Burnet v. Hormel, 287 U.S. 103, 106. And this exception has always been narrowly construed so as to protect the revenue against artful devices. See Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52.

We do not see here any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income. The pay-out of these particular assigned oil payment rights could be ascertained with considerable accuracy. Such are the stipulations, findings, or clear inferences. In the *O'Connor* case, the pay-out of the assigned oil payment right was so assured that the purchaser obtained a $9,990,350 purchase money loan at 3½ percent interest without any security other than a deed of trust of the $10,000,000 oil payment right, he receiving 4 percent from the taxpayer. Only a fraction of the oil or sulphur rights were transferred, the balance being retained.[4] Except in the *Fleming* case, which we will discuss

[4] Until 1946 the Commissioner agreed with the contention of the taxpayers in these cases that the assignment of an oil payment right was productive of a long-term capital gain. In 1946 he changed his mind and ruled that "consideration (not pledged for development) received for the

later, cash was received which was equal to the amount of the income to accrue during the term of the assignment, the assignee being compensated by interest on his advance. The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property.

These arrangements seem to us transparent devices. Their forms do not control. Their essence is determined not by subtleties of draftsmanship but by their total effect. See Helvering v. Clifford, 309 U.S. 331; Harrison v. Schaffner, 312 U.S. 579. We have held that if one, entitled to receive at a future date interest on a bond or compensation for services, makes a grant of it by anticipatory assignment, he realizes taxable income as if he had collected the interest or received the salary and then paid it over. That is the teaching of Helvering v. Horst, 311 U.S. 112, and Harrison v. Schaffner, supra; and it is applicable here. As we stated in Helvering v. Horst, supra, 117, "The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them." There the taxpayer detached interest coupons from negotiable bonds and presented them as a gift to his son. The interest when paid was held taxable to the father. Here, even more clearly than there, the taxpayer is converting future income into present income.

Second, as to the *Fleming* case. The Court of Appeals in the *Fleming* case held that the transactions were tax-free under [§1031(a), relating to "like kind" exchanges]. . . .

We agree with the Tax Court, 24 T.C. 818, that this is not a tax-free exchange under [§1031(a)]. Treasury Regulations . . . provide in [§1.1031(a)-1(b)] as respects the words "like kind," as used in [§1031(a)], that "One kind or class of property may not . . . be exchanged for property of a different kind or class." The exchange cannot satisfy that test where the effect under the tax laws is a transfer of future income from oil leases for real estate. As we have seen, these

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assignment of a short-lived in-oil payment carved out of any type of depletable interest in oil and gas in place (including a larger in-oil payment right) is ordinary income subject to the depletion allowance in the assignor's hands." G.C.M. 24849, 1946-1 Cum. Bull. 66, 69. This ruling was made applicable "only to such assignments made on or after April 1, 1946," I.T. 3895, 1948-1 Cum. Bull. 39. In 1950 a further ruling was made that represents the present view of the Commissioner. I.T. 4003, 1950-1 Cum. Bull. 10, 11, reads in relevant part as follows:

"After careful study and considerable experience with the application of G.C.M. 24849, supra, it is now concluded that there is no legal or practical basis for distinguishing between short-lived and long-lived in-oil payment rights. It is, therefore, the present position of the Bureau that the assignment of any in-oil payment right (not pledged for development), which extends over a period less than the life of the depletable property interest from which it is carved, is essentially the assignment of expected income from such property interest. Therefore, the assignment for a consideration of any such in-oil payment right results in the receipt of ordinary income by the assignor which is taxable to him when received or accrued, depending upon the method of accounting employed by him. Where the assignment of the in-oil payment right is donative, the transaction is considered as an assignment of future income which is taxable to the donor at such time as the income from the assigned payment right arises.

"Notwithstanding the foregoing, G.C.M. 24849, supra, and I.T. 3935 supra, do not apply where the assigned in-oil payment right constitutes the entire depletable interest of the assignor in the property or a fraction extending over the entire life of the property."

The pre-1946 administrative practice was not reflected in any published ruling or regulation. It therefore will not be presumed to have been known to Congress and incorporated into the law by re-enactment. See Helvering v. N.Y. Trust Co., 292 U.S. 455, 467-468. Cf. United States v. Leslie Salt Co., 350 U.S. 383, 389-397. Moreover, prior administrative practice is always subject to change "through exercise by the administrative agency of its continuing rule-making power." See Helvering v. Reynolds, 313 U.S. 428.432.

oil payment assignments were merely arrangements for delayed cash payment of the purchase price of real estate, plus interest. Moreover, [Regs. §1.1002-1(c)] states that the "underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated." Yet the oil payment assignments were not conversions of capital investments, as we have seen.

Reversed.

NOTE

1. *Depletion and the Lake case.* As the taxpayer in the *Lake* case viewed its transfer of the oil payment, it was entitled to report $600,000 as capital gain and the transferee of the oil payment was entitled to deduct cost or percentage depletion on his "economic interest" in the oil in place. The court, however, held that the transferor realized ordinary income subject to depletion, which presumably bars the transferee from deducting depletion on the same $600,000 worth of oil. How should the transferee — whose basis for the oil payment was $600,000 — report his gain or loss on the transaction? If he receives more than $600,000, is he — or anyone else — entitled to deduct percentage depletion on the excess?

2. *"ABC transactions."* If A, the owner of a working interest in oil property with a fair market value of $15 million, sells it to B for that amount, A will be entitled to report his profit as capital gain (assuming he is not a dealer in such property) and B will be entitled to deduct either cost depletion based on his $15 million investment or percentage depletion based on the gross income from the oil property. The same results will obtain if B must borrow (e.g., $10 million) to finance the purchase, except for his right to deduct the interest paid on the loan. Since B will have to repay the loan with after-tax dollars, an alternative method of financing such purchases from A has been developed — the "ABC transaction." Instead of selling the entire working interest to B, A reserves an oil payment (e.g., in the amount of $10 million, plus interest) and sells the working interest to B, subject to this reserved payment, for $5 million. At the same time, or later, A sells the oil payment for $10 million to C, who finances the acquisition by borrowing $10 million from a bank, insurance company, or other investor, pledging the oil payment as security.

In a series of unpublished rulings on ABC transactions, the Internal Revenue Service has ruled that A is entitled to capital gain on the sale of both the working interest and the reserved oil payment. (As to the latter, note that I.T. 4003, quoted in footnote 4 of the *Lake* opinion, implies that the sale of an oil payment may be reported as capital gain if the payment "constitutes the entire depletable interest of the assignor in the property.") The ABC rulings also state that the $10 million received by A from C is not includible in B's gross income and that C is entitled to depletion on account of the oil payment. The ABC transaction thus reduces the amount that B must pay for the property (by $10 million in the foregoing example); this amount is also eliminated from B's gross income from the property and hence reduces B's deduction for percentage depletion by $2.75 million (i.e., 27½ per cent of $10 million). But C has a $10 million basis for the oil payment, which can be fully recovered by using cost depletion. Thus, the only taxable income arising from the production that is devoted to the oil payment is C's margin or profit, which will be the modest difference between the interest received by C on the $10 million oil payment and the interest that C must pay to the lender. For B, there is no substantial economic difference between a two-party transaction and an ABC transaction, since in the latter case he pays $10 million less for, and receives $10 million less from, the property; but the ABC transaction reduces his taxable income by $6.25 million (i.e., $10 million less $2.75 million of depletion). In practice, this comparison between the two alternatives must be modified to take account of the interest factor, the pay-out period, and certain limitations on B's use of percentage depletion, but ordinarily these modifications will not impair the essential validity of the comparison itself.

If the ABC transaction were viewed as a purchase by B of both the working interest *and* the oil payment, coupled with a pledge of the latter to C for a non-recourse loan,

how would its tax consequences be altered? Does the *Lake* case buttress, undermine, or leave unaltered the industry's case for the ABC transaction?

For discussion of the possibility of using the ABC pattern to finance the acquisition of real estate by having A sell the property to B subject to a leasehold sold simultaneously to C (who then leases the property to a tenant on a long-term "net" lease), see Tanenbaum, The ABC Technique of Financing Real Estate Acquisitions: The Tax Motivated Leasehold, 111 U. of Pa. L. Rev. 161 (1962).

3. *Sales price measured by income.* On retirement from active service, stockholders of a corporation were required by the corporate charter to surrender their shares to the corporation; at the shareholder's option, he was entitled to receive in exchange either a lump sum payment or a certificate providing for payments equal to the dividends payable on the surrendered stock for the subsequent 10-year period. In Marshall's Estate v. Commissioner, 20 T.C. 979 (1953), it was held that a shareholder who elected to exchange his stock for a 10-year certificate could report the receipts thereunder as capital gain rather than ordinary income. Does the subsequently decided *Lake* case impair the validity of this decision? See also Ayrton Metal Co. v. Commissioner, 299 F.2d 741 (2d Cir. 1962), to the effect that "the fact that payment for a capital asset is measured in terms of income or profits does not necessarily change the payments into ordinary income." But see Wiseman v. Halliburton Oil Well Cementing Co., 301 F.2d 654 (10th Cir. 1962), where the taxpayer relinquished an exclusive license to use, and grant sub-licenses to use, a patented process; in exchange, the owner of the process granted the taxpayer a non-exclusive license to use it and agreed to pay the taxpayer one third of the royalties received from other licensees. On the ground that the amounts received by the taxpayer under this agreement constituted a substitute for amounts it would have earned had it retained its right under the original agreement to issue sub-licenses, they were held to be taxable as ordinary income rather than capital gain.

4. *"Bootstrap" sales.* What if a capital asset is sold to an impecunious third party, with the purchase price to be paid by installments dependent either in amount or in time upon the income produced by the transferred property? The following is an intra-office memorandum of the Internal Revenue Service, reprinted in Hearings, Subcommittee of House Ways and Means Committee, 83d Cong., 1st Sess. 1368-1369 (1953):

> In 1941, the Lasdon family group — consisting of about 10 individuals — acquired from their wholly owned corporation, for the consideration of $10,000, certain patents and patent applications relating to sulfadiazine. On the following day they granted to the American Cyanamid Co., an exclusive license to exploit sulfadiazine in return for a royalty of 16 percent of the net sales value thereof, plus 25 percent of royalties received from sublessees, the license to continue for 18 years. On an application made by the Lasdons in 1945, the Bureau ruled that the "inventions and the patents, patent applications and contract rights pertaining thereto" constituted capital assets, that they had been held for more than 6 months, and that gain or loss from the sale thereof would constitute long-term capital gain or loss. About a year and a half later the Lasdons established the Lasdon Foundation, Inc., which was to support certain projects in medical research. In September 1947, this foundation was held to be exempt under section 101(6) [now §501(c)(3)]. In that same month, the Lasdons proposed to sell to the foundation the sulfadiazine patents and patent applications and their contract rights under the contract with American Cyanamid for the consideration of $6,500,000, or 90 percent of the payments to be received under the American Cyanamid contract, whichever was the lesser. The foundation would assume the Lasdons' obligation under the 1941 license contract to protect the inventions, and Cyanamid would accept this substitution of the foundation for the Lasdons individually. The foundation would be prohibited from selling the Cyanamid license contract without the consent of Cyanamid, and the Lasdons would guarantee the foundation's performance of the licensor's obligations under the 1941 contract. On the basis of this proposal, the Lasdons requested a prospective ruling that this transaction would be deemed to be the sale of a capital asset, the gain therefrom returnable on the installment basis. In a separate request, the foundation requested [a ruling] that its receipt of proceeds under the Cynamid license contract would be tax exempt. In

March 1948, the Lasdons amended their plan by making the consideration payable by the foundation to be the fixed sum of $6 million payable in equal quarterly sums over a period of 10 years. In September 1947, when the original requests were filed, the foundation had approximately $90,000 worth of assets. Over the life of the Cyanamid license contract the Lasdons have heretofore received from Cyanamid an average of approximately $1,100,000 annually. . . .

There are now pending . . . 4 cases, in addition to this case, all 5 of which involve prospective transactions and have these elements in common: (a) a "seller" who is a taxpaying individual or corporation; (b) a "buyer" which is a tax-exempt corporation; (c) a "sale" by the first to the second of these parties of income-producing property; (d) immediately prior to the transfer, the buyer has no substantial amount of assets; (e) provision is made for the deferred payment of the consideration by the "buyer," and it is obvious that such consideration must be derived from income produced by the property transferred. In all of these cases, the "seller" desires a ruling holding the transaction to be the sale of a capital asset, the proceeds of which are returnable on the installment basis.

According to the subcommittee's report, an attorney in the chief counsel's office of the Internal Revenue Service recommended against issuing a favorable ruling, four different law firms were unsuccessful in obtaining a ruling, and one was finally issued only after "endeavors of a less orthodox nature" were initiated by the taxpayers. Report on Internal Revenue Investigation, Subcommittee on Administration of the Internal Revenue Laws, House Committee on Ways and Means, 83d Cong., 1st Sess. 10-11 (1953); see also Mayock v. Commissioner, 32 T.C. 966 (1959) (tax liability of Lasdons' attorney on $65,000 paid to him in cash in connection with ruling).

The Internal Revenue Service has litigated a number of "bootstrap" purchase cases, but the taxpayers have generally prevailed. The leading case is Brown v. Commissioner, 325 F.2d 313 (9th Cir. 1963), upholding the transaction, in which certiorari was granted; see also Kolkey v. Commisioner, 254 F.2d 51 (7th Cir. 1958); Royal Farms Dairy Co. v. Commissioner, 40 T.C. 172 (1963), and cases there cited.

5. *References.* For the *Lake* case, see the exhaustive examination of Lyon and Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case, 17 Tax L. Rev. 295 (1962); Note, The P. G. Lake Guides to Ordinary Income: An Appraisal in Light of Capital Gains Policies, 14 Stan. L. Rev. 551 (1962); Benjamin and Currier, The Supreme Court and Taxation of Oil, Gas, and Production Payments: The Lake Cases, 19 La. L. Rev. 579 (1959).

On the ABC transaction, see Benjamin and Currier, supra; Appleman, The ABC Deal, 11 Inst. on Oil and Gas Law and Taxation 519 (1960); Wilkinson, ABC Transactions and Related Income Tax Plans, 40 Texas L. Rev. 40 (1961); articles by Early, Rowen, and Appleman, 21 N.Y.U. Inst. on Fed. Taxation 939 et seq. (1963).

On bootstrap transactions, see Lanning, Tax Erosion and the "Bootstrap Sale" of a Business, 108 U. of Pa. L. Rev. 623 and 943 (1960); MacCracken, Selling a Business to a Charitable Foundation, 1954 So. Calif. Tax Inst. 205.

COMMISSIONER v. PITTSTON COMPANY

252 F.2d 344 (2d Cir. 1958), cert. denied, 357 U.S. 919 (1958)

Before CLARK, Chief Judge, MOORE, Circuit Judge, and SMITH, District Judge.

SMITH, District Judge:

This is a petition by the Commissioner of Internal Revenue for review of a decision of the Tax Court of the United States reported in 26 T.C. 967, holding the taxpayer The Pittston Company entitled to treat the sum of $500,000 received in 1949 as consideration for the termination of an exclusive contract to purchase the output of Russell Fork Coal Company's leased Pike County coal mines, as long term capital gain, derived from a sale or exchange within the meaning of [§1222(3)]. . . .

[In 1944 Russell held a lease on certain real estate in Pike County, Kentucky.

In order to enable it to install a coal mining plant thereon Pittston, pursuant to a contract with Russell dated January 25, 1944, agreed to loan Russell $250,000 to be advanced in such amounts as required for "the installation by it of a coal mining plant, and for the operation thereof." Pittston was given the right to designate a director or directors to the extent of one third of the board, and Russell's expenditures of the proceeds of the loan had to be approved by him or them. Restrictions were placed upon the payment of salaries to Russell's officers and the use of net earnings. Notes evidencing the loan were to be secured by a mortgage upon the lease and structures to be placed upon the property. At the same time Russell and Pittston made a second contract whereby Russell agreed to sell to Pittston "all of the coal which shall be mined and sold for resale from the mining plant or plants which the Seller expects to install or does install upon its leased property in Pike County, Kentucky, as set forth in the agreement executed simultaneously herewith," i.e., the loan agreement, for a period of ten years. Ten cents per ton was to be deducted by Pittston from all coal sold "pursuant to the coal sales agreement entered into simultaneously herewith" to be applied on the loan. By reason of these provisions the $250,000 loan was repaid by the end of 1948.] *

On October 14, 1949, Russell paid $500,000 to taxpayer in consideration of taxpayer's surrender of all of its rights under the coal agreement of January 25, 1944. The transaction was reflected in a letter agreement dated October 14, 1949; the letter was sent to Russell by taxpayer, and read as follows:

> In consideration of the payment by you to us of the sum of Five Hundred Thousand Dollars ($500,000), receipt of which is hereby acknowledged, it is understood that you have as of this day acquired all of our right and interest in and to the agreement dated January 25, 1944 between us, which agreement provides for the exclusive right . . . to purchase all of the coal produced by you at your Russell Fork Mine, said contract expiring by its terms on January 25, 1954.

In its income tax return for the year 1949, taxpayer reported the $500,000 as long-term capital gain. In his notice of deficiency, the Commissioner determined that this amount "was not received as the result of a sale or exchange and therefore is reportable as ordinary income." The Tax Court held that the $500,000 was taxable as long-term capital gain, not as ordinary income, and accordingly overruled the Commissioner.

The courts have not been entirely consistent in their treatment of lump sum payments received by a taxpayer for the termination of jural relations between the taxpayer and another as falling within or without the area entitled to more favored treatment as long-term capital gains rather than ordinary income. This circuit has steered a middle course. In McAllister v. C.I.R., 2 Cir., 157 F.2d 235, payment received for transfer by a taxpayer of a life interest in a trust to a remainderman was held a capital gain, Judge Frank dissenting. The McAllister holding and its possible consequences were criticized in Judge Frank's dissent and in comments on the problem in law journals (see 56 Yale L.J. 570-574 and 14 U. of Chic. L. Rev. 484-493). The court thereafter held in C.I.R. v. Starr Bros., 2 Cir., 204 F.2d 673, that payment received by a taxpayer, a New London retail druggist, for relinquishing its rights under a provision in a contract with a manufacturer, binding the manufacturer not to sell drugs to taxpayer's competitors in New London, was ordinary income and not a capital gain. In the same year, consistently with *Starr,* the court in General Artists Corp. v. C.I.R., 2 Cir., 205 F.2d 360, cert. den. 346 U.S. 866, held that payments received by a taxpayer for transfer of its contracts with a singer as his exclusive booking agent

* This portion of the statement of facts is from the dissenting opinion of Judge Moore.

to another such agent by an agreement providing for cancellation of the contracts and execution of new contracts with the singer by the transferee were ordinary income and not capital gains received as gain from sale of a capital asset. However, in C.I.R. v. McCue Bros. & Drummond Inc., 2 Cir., 210 F.2d 752, the court held a payment received by a taxpayer lessee from a landlord for vacating premises where the taxpayer had a right to continued possession under rent control laws was a capital gain from the sale or exchange of a capital asset held more than six months. In so doing the court followed the third circuit in C.I.R. v. Golonsky, 3 Cir., 200 F.2d 72, cert. den. 345 U.S. 939, holding payment received by a lessee from the landlord for cancelling the lease and surrendering the premises to be a capital gain. The court distinguished *Starr* and *General Artists* because there the contractual right was not transferred, but was released and merely vanished. The right to possession of the realty was considered a more substantial property right which does not lose its existence when it is transferred.

The Tax Court in the instant case concluded that the contractual right held by the taxpayer constituted capital assets, which petitioner does not dispute, and concluded that the right was not extinguished by its cancellation, but continued to exist as property of the transferee-payor. It distinguished *Starr* and *General Artists* on the ground that the court had held in those cases the contractual right was not transferred, but was released and merely vanished. The Tax Court says in effect that the extinguishment of a contract duty to deal only with one person transfers to the one formerly bound a right to deal with all the world. It would be more in accord with common understanding to say that the payment is solely for the termination of the right-duty relationship between the two parties to the agreement. To be sure, the same might be said of the termination of lessee's or life tenant's rights, but they have been distinguished as relating to matters of greater "substance" than mere contract rights.

The instant case appears on the facts closer to the payment for the extinguishment of the taxpayer's rights under the negative covenant in *Starr* than to the cases such as *McAllister* where a life estate was transferred to the remainderman, or the release of right to possession of realty under lease or otherwise as in *McCue* and in *Golonsky*. While the contract right here surrendered was "property" of value it carried with it no direct interest in the mine itself, or in the coal produced until delivery f.o.b. car or truck. It was a naked contract right, not in the nature of a lease or profit *à prendre*. If Russell Fork was able to do better elsewhere it might have sold its coal through anyone, responding in damages to the taxpayer, for so far as appears similar coal would have been obtainable elsewhere by taxpayer at a price. The large amount received by the taxpayer for the 4½ years the contract had to run compared with its gross returns for the 5½ years already expired,* while not explained on the record, may reflect an expectation of lower expense to the taxpayer since taxpayer no longer is financing Russell. In any case, the cancellation brought the taxpayer at one time a return which it might otherwise have realized over a relatively short period of years as ordinary income under the sales contract. Whatever brought it about, it suggests a possible method of returning future income to a taxpayer in a lump sum from the other contracting party in advance for tax avoidance purposes, which the court has been unwilling to sanction except where the consideration surrendered had more "substance" than mere contract rights.

The Congress has since the tax year here in question more fully provided for the application of the sale or exchange concept when a lease or distribution

* The facts as stated by the Court of Appeals represent the taxpayer's gross profit as about $275,000, but the stipulation in the Tax Court shows that the correct figure is about $725,000. — Ed.

agreement is cancelled, by [§1241, enacted in 1954], allowing the more favorable capital gains treatment of the amount received on cancellation, but in case of distributorships only where the distributor has a "substantial investment" in the distributorship, as in facilities for storing, processing, etc. the physical product or as in maintaining a substantial inventory. This amendment is not applicable in this case, and of course no showing was made as to whether such a substantial investment in facilities or inventory was or was not maintained. The amendment is of little assistance in interpreting the original provision for we cannot tell whether the intent of Congress was to broaden or narrow the capital gains on sale or exchange exception to the income tax, and its apparent result falls somewhere between the contentions of the opposing parties here. [S. Rept. 115, 444.] The heavy burden of income taxation inevitably leads to the broadening of exceptions such as the capital gains provision. This court has endeavored to define what it conceived to be the limits to this exception in *Starr* and *United Artists* by a somewhat literal definition of "sale or exchange." Even though the logic of setting the limit by drawing the line where it now is may be open to debate, any line set must be to some degree arbitrary. This case falls outside the limit thus far set for the exception by this court. We should leave further expansion of the exception, to include the release of naked contract rights as a "sale," to legislative action.

The judgment of the Tax Court is reversed and the case is remanded for entry of judgment in favor of the Commissioner in accordance herewith.

MOORE, Circuit Judge (dissenting):

. . . [T]he business arrangement between these companies was not confined to a "naked contract right" (as the majority holds) to buy coal but was an integrated transaction whereby Pittston financed the construction of a coal mining plant on Russell's leasehold and agreed to take the entire output, f.o.b. the mine, for ten years with conditional extension possibilities. The two simultaneous agreements, each referring to the other, evidenced the transaction. These contract rights can only be rendered "naked" by stripping from them and discarding the raiments which the parties found to be essential. To say that Russell despite its commitment could sell to anyone responding only in damages on the assumption that similar coal could have been obtained elsewhere (as to which there is no proof in the record) is, first, to suggest that these companies would not honor their mutual obligations and, second, that the courts in view of the investment of Pittston in the Russell operation and the nature of the agreement (entire output for a period of years) would restrict relief to damages. "Contracts for the delivery of goods will be specifically enforced, when by their terms the deliveries are to be made and the purchase price paid in installments running through a considerable number of years" . . . Specific performance is particularly applicable to a contract "to continue over a period of years without rigidity of price" . . .

The mutual rights and obligations created by these two agreements were most substantial. Russell as effectively deprived itself of any other use of its property for ten years as the owner of a building granting a leasehold for ten years to a tenant who had loaned the money to construct it. Russell could only regain for itself the unrestricted use of its property by a surrender by Pittston tantamount to the voluntary termination of a leasehold prior to the expiration date. Pittston, in turn, not only had an investment in Russell's lease, plant and equipment but had a property right to acquire the entire output of the Russell mine which proved to be a right of substantial value.

Nor can the $500,000 payment be regarded as anticipated income for the five remaining years of the contract. As the majority concede, the large amount paid

bears no relationship to future income projected on the basis of the gross income realized by Pittston for the previous five and one-half years. Pittston's income was not assured or guaranteed; it was entirely dependent upon its ability to conduct its business operations at a profit. The $500,000 paid was the value to Russell to get its property back and also represented Pittston's opinion of the contract's worth. If the contract were assigned to a third party there would be no question that the consideration received would reflect the value of the asset sold. Yet for all practical purposes Pittston by such assignment would thereby have terminated or cancelled its right to purchase coal from Russell.

In endeavoring to find a guide as to the type of transaction which will be construed as resulting in a capital gain as distinguished from ordinary income, the decisions reveal uniform consistency in holding that the surrender, termination or cancellation for monetary consideration of a capital asset results in a capital gain. Neither the petitioner nor the majority assail the correctness of the Tax Court's conclusion that the contract right here was in itself a capital asset. For this reason I must disagree with the majority that "the termination of the right-duty relationship between the two parties" results in ordinary income to the taxpayer; particularly since they concede that "the same might be said of the termination of the lessee's or life tenant's rights" which clearly produces a capital gain. Judge Goodrich noted the fallacy of this approach when he wrote "To call the transaction a cancellation or termination of a lease and not a sale is, we think, to assume the point to be decided." . . .

Searching for a firmer support, an attempt is made to find in the words "substance" or "substantial rights" whether a capital asset is involved and then give uniform treatment regardless of whether the asset is "sold" or "terminated." Prior to the decision of the majority in this case there seemed to be consistency among the various Courts of Appeals in applying this test. In 1950 the Tenth Circuit (Jones v. Corbyn, 10 Cir., 1950, 186 F.2d 450) held that the surrender of an exclusive life insurance agency to an insurance company for a lump sum payment of $45,000 was a long-term capital gain and not ordinary income. Answering the Collector's argument that the contract was not a capital asset the court said "The contract or franchise had at all times substantial value. It was capable of producing income for its owner. It was enforceable at law and could be bought and sold" (p. 452). The court's conclusion was that "By terminating the contract and transferring the business to the company, there was a sale and transfer of a capital asset within the meaning of the statute" (p. 453). In the Fifth Circuit a lessee merely surrendered to his lessor a restriction against renting any space in the block to a Variety Store for which surrender he received $20,000. Despite the fact that this was the surrender of only one of the many rights granted under the lease the court affirmed a decision of the Tax Court in holding the amount received to be a capital gain (Commissioner v. Ray, 5 Cir., 1954, 210 F.2d 390) . . . In the same year the Third Circuit . . . considered a problem of the surrender of contract rights to the exclusive product of four machines in exchange for stock in Commissioner v. Goff, 3 Cir., 1954, 212 F.2d 875, the Commissioner contending that the transfer of these rights constituted ordinary income relied on the *Starr Bros.* and *General Artists* cases in this Circuit but Judge Goodrich pointed out that "the last word on the subject in the Second Circuit is Commissioner v. McCue Bros. & Drummond, Inc., 2 Cir., 1954, 210 F.2d 752, which held that payment made by a lessor to a lessee so that he would vacate the premises was a capital gain." He found that "[T]he *Starr* and *General Artists* decisions were distinguished on the ground that the rights therein involved were less substantial." Referring to McCue Bros. & Drummond he recognized this decision as being "in accord with the cases cited above, and we think it is right" but that

"whether the Second Circuit cases are in harmony is not a matter for us to decide" (212 F.2d 875, 876). The court affirmed the Tax Court decision saying "there is certainly no doubt that the right that Saxon had to the exclusive product of these four machines was a substantial right and, if it is important, it was a right connected with the use of specific tangible property, that is, the machines themselves" (pp. 876, 877).

Legal rights should not be adjudicated by mere choice of words: "There surely cannot be that efficacy in lawyers' jargon that termination or cancellation or surrender carries some peculiar significance vastly penalizing laymen whose counsel have chanced to use them" (McAllister v. Commissioner, supra, p. 236). Moreover, here the parties did not even use the word "surrender" but said that Russell had "acquired all of our right and interest." That "there was a 'surrender' to the remainderman, rather than a 'transfer' to third persons . . . does not change the essentially dispositive nature of the transaction so far as the former property owner is concerned" (*McAllister*, supra, p. 237). So here Pittston had effectively disposed of its property interest. Whether by surrender or transfer or acquisition the legal consequences should be the same.

NOTE

1. *The Internal Revenue Service's position.* In Rev. Rul. 56-531, 1956-2 C.B., 983, the Internal Revenue Service announced that, following the *Golonsky, McCue* and *Ray* cases, it would recognize that "amounts received in consideration of the surrender or release by the tenant to the landlord of possessory rights in real estate under a lease or under a statute entitling the tenant to continue in possession following expiration of a lease, or amounts received by a tenant from the landlord in consideration of the relinquishment of a lease covenant restricting the use of the real estate by the landlord, constitute proceeds from the sale of a capital asset. . . ." On the other hand, the Service "will continue to regard the relinquishment of simple contract rights as not involving the sale or exchange of a capital asset . . . and will treat amounts received in consideration of such relinquishment as constituting ordinary income . . . ," citing the *General Artists Corp.* and *Starr Bros.* cases.

See Note, Distinguishing Ordinary Income from Capital Gain Where Rights to Future Income Are Sold, 69 Harv. L. Rev. 737 (1956).

2. *Cancellation of lease or of distributor's agreement.* Section 1241 of the 1954 Code provides a statutory guide to certain aspects of these problems. Does it insure capital gain or loss treatment for the amounts in question, or does it simply get the taxpayer over the "sale or exchange" hurdle, leaving him to establish independently that the lease or distributor's agreement is a "capital asset"? Under §1241 a distributor must have a "substantial capital investment in the distributorship." What does this mean? Is a distributor's inventory an "investment in the distributorship"? Must the investment be "substantial" in relation to the amount received by the taxpayer? Why are only distributors of goods, and not other agents and holders of franchises, included in the statute? The Senate Report states (p. 115) that "the section is limited in scope and it does not constitute a re-examination of present law relating to contracts to which the section does not specifically apply." Note that as to leases, §1241 applies to payments received by the lessee, but not to those received by the lessor, and that only amounts "for the cancellation" of a lease qualify.

3. *The case law.* Disputes over the proper treatment of amounts received on the transfer or termination of contract rights have multiplied in recent years, as the government has pressed, separately or in combination, the following arguments: the contract right was not "property"; it was not the subject of a "sale or exchange"; the amount received was a substitute for ordinary income. Among many cases, the following may be noted:

United States v. Eidson, 310 F.2d 111 (5th Cir. 1962). The taxpayers were general agents and managers of the life insurance business of an insurance company, under a

"General Agency-Managerial-Service Contract" giving them the exclusive right to solicit business and to employ agents in return for a stated percentage of the premiums paid less the company's expenses. Another insurance company acquired the outstanding policies and business of their company by a series of transactions that included a payment to the taxpayers of $170,000 for a transfer of their rights under the contract, which was promptly canceled. Held: ordinary income.

Nelson Weaver Realty Co. v. Commissioner, 307 F.2d 897 (5th Cir. 1962). The taxpayer, engaged in the business of procuring, selling, brokering, and servicing mortgage loans, was the mortgage sales and servicing agent for New York Life Insurance Company in a number of Alabama cities, under a contract that was terminable by either the taxpayer or New York Life on short notice. Another mortgage servicing company paid the taxpayer about $122,000 for transferring its rights under the contract (subject to New York Life's approval) and for delivering all of its files and papers relating to the mortgages then being serviced under the contract. Held (one judge dissenting): capital gain.

Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963). On substantially the same facts as in *Nelson Weaver Realty Co.*, supra, another panel of the Fifth Circuit held that the transaction was partly a sale of future commissions, taxable as ordinary income, and partly a sale of goodwill, files, and equipment, taxable as capital gain.

Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962). The taxpayer (Jose Ferrer) entered into a contract with the author of a novel and play based on the life of Toulouse-Lautrec, under which he had the exclusive right to produce the play on the stage in the United States and Canada, as well as the right to prevent the making of a motion picture, radio, or television version of the play for a specified period of time and the right to receive 40 per cent of the proceeds of the motion picture and other rights. When John Huston displayed an interest in producing a motion picture based on the play and starring Ferrer himself, the contract between Ferrer and the author was canceled, the author sold the motion picture rights to Huston, and Ferrer was employed to play the leading role under a contract providing for a "salary" and for "percentage compensation" dependent on the profits of the production. The Tax Court held that the latter amounts were paid to Ferrer for relinquishing his rights under the original agreement (rather than as compensation for his personal services) and that they were taxable as capital gain. The Court of Appeals, accepting the Tax Court's determination that the percentage payments were not additional salary, held that they constituted capital gain to the extent that they compensated Ferrer for his right to produce the play and to prevent a motion picture, radio, or television production, but that they were a substitute for, and taxable as, ordinary income to the extent allocable to his right under the original contract to receive a portion of the motion picture proceeds.

Holt v. Commissioner, 303 F.2d 687 (9th Cir. 1962). Under a contract for the production of motion pictures, taxpayer became entitled to a percentage of certain gross receipts to be derived by Paramount Pictures from their release. Several years later, as part of an arrangement for terminating their relationship, Paramount paid taxpayer in cash the estimated value of his claim. Held: ordinary income.

4. *Do the cases fit a pattern?* In Commissioner v. Ferrer, supra, the court summarized and classified the cases in this area as follows:

> Perhaps we can get more help from analyzing the fact situations in cases in adjacent areas, including those decided since Judge Smith's careful review in C.I.R. v. Pittston Company, 252 F.2d 344 (2 Cir.), cert. denied, 357 U.S. 919, than from the language of the opinions. Putting aside Jones v. Corbyn, 186 F.2d 450 (10 Cir. 1950), which we have disapproved, C.I.R. v. Starr Bros., Inc., 204 F.2d 673, 674 (2 Cir. 1953) and whose status in its own circuit has now become rather doubtful, Wiseman v. Halliburton Oil Well Cementing Co., 301 F.2d 654 (10 Cir. 1962), a case to which we refer below, and C.I.R. v. Goff, 212 F.2d 875 (3 Cir.), cert. denied, 348 U.S. 829, which is only dubiously reconcilable with our *Pittston* decision, the principal relevant authorities on the two sides of the line in the Supreme Court and in the courts of appeals are as follows: There is no sale or exchange of a capital asset when a lessor receives payment for releasing a lessee from an obligation to pay future rent, Hort v. C.I.R., 313 U.S. 28. The same was true of the cancellation of an exclusive distributorship, C.I.R. v. Starr Bros., Inc., 204 F.2d 673 (2 Cir. 1953); Leh v. C.I.R., 260

F.2d 489 (9 Cir. 1958), although §1241 of the 1954 Code now rules otherwise if the distributor has a substantial capital investment therein. The transfer of exclusive agency rights to a third person likewise did not qualify, General Artists Corp. v. C.I.R., 205 F.2d 360 (2 Cir.), cert. denied, 346 U.S. 866; whether it now does if the capital investment requirement of §1241 is met is another question. The sale of oil payment rights, C.I.R. v. P. G. Lake, Inc., 356 U.S. 260, the temporary taking of a taxpayer's right to use his own transportation assets, C.I.R. v. Gillette Motor Transport, Inc., supra, and the surrender of an exclusive contract to purchase coal, C.I.R. v. Pittston Co., supra, do not meet the statutory test. Neither does the receipt of a lump sum in liquidation of a percentage of the gross receipts of motion pictures otherwise payable to a producer solely in return for personal services not yet performed, Holt v. C.I.R., 303 F.2d 687 (9 Cir. 1962). On the other hand, a lessee's surrender of his lease to the lessor, C.I.R. v. Golonsky, 200 F.2d 72 (3 Cir. 1952), cert. denied, 345 U.S. 939; C.I.R. v. McCue Bros. & Drummond, Inc., 210 F.2d 752 (2 Cir.), cert. denied, 348 U.S. 829, now in effect ratified by §1241 of the 1954 Code, his relinquishment of a right to restrict the lessor's renting to another tenant in the same business, C.I.R. v. Ray, 210 F.2d 390 (5 Cir.), cert. denied, 348 U.S. 829, and his release of his entire interest to a sublessee, Metropolitan Bldg. Co. v. C.I.R., 282 F.2d 592 (9 Cir. 1960), but see Voloudakis v. C.I.R., 274 F.2d 209 (9 Cir. 1960), constitute the sale or exchange of a capital asset. So does the abandonment of an option to acquire a partnership interest, Dorman v. United States, 296 F.2d 27 (9 Cir. 1961).

One common characteristic of the group held to come within the capital gain provision is that the taxpayer had either what might be called an "estate" in (*Golonsky, McCue, Metropolitan*), or an "encumbrance" on (*Ray*), or an option to acquire an interest in (*Dorman*), property which, if itself held, would be a capital asset. In all these cases the taxpayer had something more than an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another (*Starr, Leh, General Artists, Pittston*), or by rendering services (*Holt*), or by virtue of ownership of a larger "estate" (*Hort, P. G. Lake*). We are painfully aware of the deficiences of any such attempt to define the wavering line even in this limited area, but it is the best we can do. We add, with greater confidence, that more recent cases, such as *McCue & Drummond, Ray, Metropolitan,* and *Dorman,* have moved away from the distinction, relied upon to some extent in *Starr Brothers* and *General Artists,* between a sale to a third person that keeps the "estate" or "encumbrance" alive, and a release that results in its extinguishment. Indeed, although reasoning from another section of a statute so full of anomalies is rather treacherous business, we take §1241 of the 1954 Code as indicating Congressional disenchantment with this formalistic distinction. . . . Tax law is concerned with the substance, here the voluntary passing of "property" rights allegedly constituting "capital assets," not with whether they are passed to a stranger or to a person already having a larger "estate." [304 F.2d at 130-131.]

5. *Discount bonds and other obligations.* If a bond is issued at a discount, the purchaser's profit when it is retired at face amount is the equivalent of interest. Despite this fact, it was held in Commissioner v. Caulkins, 144 F.2d 482 (6th Cir. 1944), that the purchaser realizes capital gain when the bond is paid at maturity. The court rested its decision on the statutory provision (§1232(a), infra page 583) that the retirement of a bond is to be treated like a sale or exchange:

> Clearly $20,000 was the amount received on the retirement of the certificate, and under the plain wording of [§1232(a)], it was taxable as a capital gain. A provision that the increment in such cases should be taxable under [§61(a)] might or might not have been wise and fair; but Congress has not enacted it, and the courts cannot supply it by judicial legislation. [144 F.2d at 484.]

Legislative legislation was the result; §1232 is now qualified to insure that the interest represented by the original discount will be taxed as ordinary income rather than capital gain, subject to exceptions if the original issue discount was minimal or if the bond was purchased by the taxpayer at a premium.

In addition to being prospectively rejected by Congress, the *Caulkins* case was rejected by a number of courts even for pre-1954 transactions: United States v. Harrison, 304 F.2d 835 (5th Cir. 1962); but see Midland-Ross Corp. v. United States, 214 F. Supp. 631 (N.D. Ohio, 1963).

The *Caulkins* problem did not arise with Series E war bonds (and certain other United States bonds), even though issued at a discount, because §22(c) of the Second Liberty Bond Act, as amended, 49 Stat. 21 (1935), requires the increment to be reported as ordinary income. A cash basis taxpayer may report the income either annually, as the redemption value increases, or at maturity; and if the bond is held for a second 10-year period, he may postpone reporting the income until final maturity. §454(a) and (c).

Even though a bond is issued at face value rather than at a discount, a taxpayer who buys it at a discount because interest coupons have been detached enjoys the equivalent of interest on his investment when he receives the principal at maturity. Section 1232(c) requires the gain on such "stripped" bonds to be reported as ordinary income to the extent that it constitutes implicit interest.

See generally Zafft, Discount Bonds — Ordinary Income or Capital Gain? 11 Tax L. Rev. 51 (1955).

6. *Deferred payment for capital assets — "implicit" interest.* If a taxpayer sells a capital asset (adjusted basis: $500,000) for $1,000,000, to be paid in ten annual installments of $100,000, without interest until after maturity, the debt being evidenced by ten bonds or promissory notes, does the taxpayer realize $500,000 of capital gain, or is the profit partly capital gain and partly imputed interest on postponed payments of the sales price? Before 1964, the courts did not ordinarily treat any part of the profit as interest income. See Paine v. Commissioner, 236 F.2d 398 (8th Cir. 1956); Kingsford Co. v. Commissioner, 41 T.C. No. 64 (1964).

By virtue of §483 (enacted in 1964), however, the interest element in such deferred payments must be treated as ordinary income, unless the sales price is fixed and does not exceed $3,000, the property is neither a capital nor a §1231 asset, or certain other conditions are met. Moreover, §483 applies even if the property is sold at a loss. For an analogy, see §163(b), permitting the taxpayer who buys personal property on the installment plan to deduct the implicit interest charged by the seller, even though the interest charge is not separately stated.

3. *Payment for Personal Services*

McFALL v. COMMISSIONER
34 B.T.A. 108 (1936)

The Commissioner determined deficiencies in income tax for 1929 of $15,027.-44 as to McFall and $12,235.73 as to McGowan, holding as to each that $175,000 which he received in that year was ordinary income and not capital gain.

Findings of Fact

After preliminary negotiations, the petitioners, under date of December 31, 1926, made written contracts with the Sparta Foundry Co. whereby petitioners agreed to give their services as superintendent and metallurgist, respectively, and the corporation employed them as such for five years and agreed to pay them each $100 a week, plus one sixth of its annual profits computed as prescribed. The contract, so far as appears, was continuously performed in 1927 and 1928 by both employer and employee. McFall had meanwhile bought some Sparta shares, and on June 21, 1928, had become a director. McGowan was a shareholder from the beginning, and on June 21, 1928, became secretary and treasurer.

On April 2, 1929, A. W. Clutter & Co. made a written agreement with each petitioner whereby petitioner agreed to sell and Clutter & Co. to buy "all right,

title and interest of the vendor in and to said employment contract for the sum of $175,000 payable at . . . Grand Rapids . . . on or before June 5, 1929, against delivery of the original employment contract . . . accompanied by a valid assignment of said contract which in the opinion of counsel for the purchaser validly transfers to the purchaser all right, title and interest of the vendor in said employment contract." This agreement of petitioners was independently made and not related to any plan of theirs for corporate financing or stock readjustment. A week or so later, petitioners learned that it was part of such a plan of Clutter & Co. Thereafter Clutter & Co., among other terms, agreed with the corporation and with a number of shareholders to secure petitioners' release of the corporation from the employment contracts in consideration for 8,088 shares. Petitioners caused their contracts to be delivered to Clutter & Co. in May 1929, and received the latter's promissory notes for $175,000 each. On June 5, 1929, they received checks for $175,000 and releases from the Sparta corporation from their obligations under the employment contracts.

The financial plan proceeded to a conclusion in 1929. The corporation, on its 1929 income tax return, deducted $404,400, the value of the 8,088 shares, as "Expense of Obtaining Release of Liability and Cancellation of Profit-sharing Contracts," and the Commissioner allowed the deduction.* The petitioners each treated the $175,000 as capital net gain. . . . The Commissioner has determined the amount to be ordinary income.

Opinion

STERNHAGEN: The Commissioner first thought, when determining the deficiency, that what petitioners received from Clutter & Co. was by way of damages for a supposed breach of the contract of employment. But there is nothing to support such a hypothesis either as to breach or damage, and this contention is not now made.

The petitioners' contention is that they sold their contracts in 1929, that the contracts were property, that they had owned the contracts since 1926, more than two years,† and that the resulting gain, admitted to be $175,000 each, was a capital net gain under the Revenue Act of 1928, section 101, and not ordinary income. The Government argues, (1) that there is nothing to bring the 1929 transaction within section 101, Revenue Act of 1928, as a sale or exchange of capital assets, for there was no property transferred; (2) that there was only a termination by the parties of their contracts as a part of a wider plan, the effect of which was an anticipation by petitioners of their contractual compensation for services; and (3) if petitioners could be regarded as selling anything of their contracts, it was nothing they had held for two years but only a contingent right to receive compensation in the future.

The determination of deficiencies must, we think, be sustained. Petitioners did not sell their contracts, for inherently this they could not do. The contracts bound them to perform services of skill. Arkansas Valley Smelting Co. v. Belden Mining Co., 127 U.S. 379. Before they had any contractual rights which they could sell, they were obligated to perform services for the company. All past services had been fully paid for and there was no due and unpaid amount to constitute a chose in action subject to assignment. On April 2, 1929, there was

* Although the findings of fact do not fully disclose the mechanics of the transaction, evidently the corporation transferred 8088 of its shares to Clutter & Company as consideration for Clutter's having paid the taxpayers for their releases. — ED.

† Under the Revenue Act of 1928, the holding period was part of the definition of "capital assets"; the term including only property held for more than two years. — ED.

a right of petitioners to continue to perform service and then to be paid — to persist in their contractual relation for its agreed term. While this right is property in the constitutional sense in that it could not be arbitrarily legislated away, it is not capital. Beals v. Commissioner, 82 Fed. (2d) 268. It is a continuing right which goes hand in hand with performance. Before performance it is in embryo, and after payment it is exhausted. Obviously it is not the sort of property which is susceptible of ownership for a length of time as is a share of stock, a bond, or a thing. If services were performed and payment withheld for two years thereafter, there might be another question. . . .

There is, we think, no need to attempt a discussion of the various meanings in law of the word "property," or to define the term as used in [§1221]. The purpose of the statute, whether it be liberal or strict, is not served by including within it the contractual expectation of receiving pay for services not yet performed. The petitioners argue that they are like a lessor having a lease more than two years old, for a term still to run, who "sells" his remaining leasehold interest — the right to rent — for a lump sum. But this does not help their case, for if the analogy holds good, such a transfer is of the right to what is to come; and, like this case, is not the basis of a statutory capital gain. Nothing owned for two years has been sold, but only a potential right to be paid contemporaneously with performance.

Holding, for this reason, that the amount received was not a statutory capital gain, it is not necessary to agree with respondent's argument that petitioners were receiving in advance the pay which they would have received and for that reason the amount was ordinary income; or that petitioners were parties to a general plan to readjust the business and this was the price to them of ending their contract, and not of selling it. Our decision is sufficiently founded, we think, upon the transactions as they were stated by the parties themselves. It may be, however, that the anomalous sale by petitioners of their rights in a personal contract which they had yet to perform, to another not in position to perform it, for cash, straightens out in the subsequent treatment of the contract. For notwithstanding the legal forms which were employed or the artificial conception that the contract was sold for cash, ultimately the parties to it abrogated it in the full light of the earlier transactions. It is not, therefore, a stretch of reason to say that this is what, in a layman's way, the petitioners had intended throughout their negotiations and agreement with Clutter & Co. to be understood as promising to do — to hold themselves bound, for a price, to terminate their employment contracts. Clearly, if the agreement with Clutter & Co. had been thus stated, the cash consideration received would have had no semblance of sale of property held for over two years.

Judgment will be entered for the respondent.

NOTE

1. *Profit-sharing contracts.* Note that the taxpayers were to receive a share of the corporation's profits for their services. If they had established that a change in economic conditions had made their profit-sharing arrangement far more valuable than their services could be worth to the corporation, could the "excess value" of the contract be taxed as capital gain on a sale? If they were to receive a share of the corporation's profits in exchange for not competing with it for a specified future period, would the proceeds of a sale of the contract qualify as a capital gain? Consider the relationship of the *Lake* case to such transactions.

See O'Neill v. Commissioner, ¶64,003 P-H Memo T.C. (sale by lawyer of contract to receive percentage of sales price for negotiating sale of client's business; held, ordinary income).

2. *Sale of claim created by personal services.* In *McFall,* the court reserved judgment on the proper treatment of a past-due claim for payment for personal services already rendered. But see §1221(4), enacted in 1954. Does §1221(4) prevent a person who buys a wage claim at a discount (e.g., because the employer is in financial distress and unable to pay promptly) from reporting his profit on a resale of the claim as capital gain? Does it insure that he will enjoy an ordinary loss on reselling the claim for less than its cost, despite his having purchased the claim as an investment? How would a loss arising from his inability to collect the claim be treated?

3. *Employee stock options.* In 1950, Congress enacted a complex provision granting capital gain treatment to so-called "restricted stock options." If the option price was 95 per cent or more of the stock's fair market value when the option was granted, if the shareholder did not sell the stock until more than two years after the option was granted and six months after it was exercised, and if certain other conditions were satisfied, the shareholder realized no gain when the option was granted or exercised, and was permitted to report his profit on the sale (i.e., the difference between his cost and the sales price) as capital gain. Thus, for employees who met the statutory requirements, the "restricted stock option" was similar to the "proprietary stock option" of pre-1946 case law, discussed supra page 44.

President Kennedy's 1963 Tax Message recommended a return to the result in the *LoBue* case, under which the difference between the option price and the value of the stock would be taxed as ordinary income when the option was exercised. In the Revenue Act of 1964, Congress responded to this proposal by eliminating the "restricted stock option" of pre-1964 law (except as to options granted or contracted for before 1964), and substituting the "qualified stock option" of §422. To qualify under this provision, the option must be granted pursuant to a plan approved by the corporation's shareholders. may not run for more than five years, must specify a price equal to or greater than the value of the stock when the option is granted, and meet certain other requirements; employees who own directly or constructively more than a specified percentage of the corporation's stock (5 to 10 per cent, depending on the amount of the corporation's equity capital) may not participate. To obtain the maximum tax benefit, the employee must hold the stock for at least three years after the option is exercised. The 1964 legislation also provides (§423) for "employee stock purchase plans," under which tax advantages comparable to those enjoyed by pre-1964 "restricted stock options" are accorded to certain plans that are open to a broad spectrum of employees, provided that no more than $25,000 of stock (by value at the time the option is granted) accrues for purchase per employee per year. Employees owning directly or constructively five per cent or more of the corporation's stock are excluded from participation.

Stock options that do not meet the statutory requirements are governed by the case law considered supra pages 45-46.

See Sellin, Taxation of Deferred Employee and Executive Compensation 530-669 (1961); Griswold, The Mysterious Stock Option, 51 Ky. L.J. 246 (1962); Rudick, Compensation of Executives Under the 1954 Code, 33 Taxes 7 (1955).

4. *Employee participation in affiliated enterprises.* Time Magazine (May 18, 1953) contained this report on the then recent financial success of the Ford Motor Company:

> The management team that put the whole works in the black is getting rewards commensurate with its achievement. To get the new men the Ford company wanted — and to keep valuable old hands from being lured away — the Ford brothers let the top brass write out their own incentive plan. A new company, Dearborn Motors, Inc. was set up by the executives as the selling agent for tractors, and the stock was split among Breech, former Sales Manager Jack Davis, Production Boss Del Harder, Labor Boss John Bugas, Ford Division Boss Crusoe and eight others.
>
> The Ford company will soon buy up the stock of Dearborn Motors at a price which will give the holders huge capital gains. . . .

When common stock of Ford Motor Company was sold to the public in 1956, the prospectus gave the following details on the incentive plan described by the Time article:

> From 1947 to July 31, 1953 Dearborn Motors Corporation, the stockholders of which included certain directors and officers of the Company and their families, was

engaged in the distribution in the United States, Canada and elsewhere of Ford tractors pursuant to agreements with the Company, and in the manufacture and distribution of other farm equipment and implements and related parts and accessories. During the seven month period preceding the latter date, sales by the Company to Dearborn of tractors and related parts amounted to $62.4 million. The Company terminated the arrangement with Dearborn as of July 31, 1953, and on that date the Company . . . acquired such of the assets of Dearborn . . . as the Company considered would be useful to it in the business of manufacturing and distributing Ford tractors and a line of farm equipment, implements and accessories. These assets, which included among other things land and office and other buildings, inventories, accounts receivable, and machinery and equipment, constituted substantially all of the assets of Dearborn . . . other than cash and other than the assets employed by Dearborn's wholly owned subsidiary, Dearborn Motors Credit Corporation in the financing of tractors and other farm implements and equipment at wholesale and retail. The consideration paid by the Company . . . for these assets was $13,790,027 in cash and the assumption by the Company . . . of liabilities aggregating $3,041,656. The face amount of the accounts receivable and the cost to Dearborn, less depreciation and other charges to income, of the additional assets acquired, amounted in the aggregate to $14,801,301.

Dearborn Credit has continued to engage in a financing business, and during the past three years has financed, and currently is financing, more than half of the wholesale sales of tractors, farm equipment and implements by the Company's distributors to their dealers and smaller portions of the purchases of such products from the Company by such distributors and of retail sales by their dealers.

Another unusual compensatory device that has been recently employed by some publicly held corporation is "phantom" or "shadow" stock: employees are entitled to benefits on retirement measured by the dividends paid on the corporation's stock during the employment period, plus the appreciation in value on the number of "phantom" shares allocated to the employee. For discussion, see Note, Phantom Stock Plans, 76 Harv. L. Rev. 619 (1963).

5. *Other capital gain opportunities for employees.* Section 1240 permits certain amounts received by an employee on termination of employment, under a long-term employment agreement, to be reported as capital gain. This provision was allegedly enacted for the benefit of Louis B. Mayer; Cary, Pressure Groups and the Revenue Code: A Requiem in Honor of the Departing Uniformity of the Tax Laws, 68 Harv. L. Rev. 745, 747-749 (1955). Section 402(a)(2) provides that certain distributions by an exempt employees' trust are to be taxed as capital gain, rather than ordinary income. Both §1240 and §402(a)(2) use the capital gain provisions as an averaging device; with them, compare the more general approach to averaging of above-normal amounts of income under §§1301-1305, infra pages 827 et seq.

6. *References:* Browne, Capital Gains Opportunities for Employees, 20 N.Y.U. Inst. on Fed. Taxation 103 (1962); Miller, Capital Gains Taxation of the Fruits of Personal Effort Before and Under the 1954 Code, 64 Yale L.J. 1 (1954); Steadman, Capital Gains as Applied to Executive Compensation, 16 Bus. Law. 643 (1961); Goodman, Capital Gains Under Pension, Profit-Sharing and Stock Bonus Plans, 1963 So. Calif. Tax Inst. 339.

4. *Anticipatory Transactions*

RHODES' ESTATE v. COMMISSIONER
131 F.2d 50 (6th Cir. 1942)

Before HAMILTON, MARTIN, and MCCALLISTER, Circuit Judges.

Per Curiam.

On petition for review of a decision of the United States Board of Tax Appeals, it appears from the record that on November 18, 1937, the Carroll Furniture Company of Atlanta, Georgia, declared a cash dividend of $20.00 per share

payable on December 18, 1937, to stockholders of record at 12:00 o'clock noon on November 26, 1937. The taxpayer, Herman W. Rhodes, was the record owner of 600 shares of stock of said company on each of the three said dates.

The taxpayer offered to sell his dividend right for $11,925.00 to C. H. Patton of Memphis, Tennessee, an intimate friend. The offer was accepted and on December 7, 1937, Patton borrowed $12,000.00 from a bank for the purpose of making the purchase and pledged the assigned dividend right as collateral for the loan.

The check in payment of said dividend when issued on December 18, 1937, was made payable to Patton, who indorsed it to the bank from which he had obtained the loan, and the bank stamped the note paid and returned it to Patton.

The question is whether the amount received by the taxpayer from Patton should be treated as ordinary income as held by the Board, or whether such amount constitutes capital gain which is available as an offest against capital losses as the petitioner contends.

In our opinion under the circumstances here present, the sum received by the taxpayer was not capital gain as that phrase is used in [§1221(1)], but was taxable as ordinary income under [§61(a)]. Compare Helvering v. Horst, 311 U.S. 112; Helvering v. Eubank, 311 U.S. 122; Harrison v. Schaffner, 312 U.S. 579.

The order of the Board is affirmed.

NOTE

1. *Sale of stock with dividend right.* Would the result have been different if the taxpayer had sold the dividend right before the record date (November 26)? If the taxpayer had sold the *stock* on December 7, reserving the right to collect and retain the dividend, to whom would it be taxable? See Regs. §1.61-9(c), noting especially the qualifying adverb "ordinarily" in the second and third sentences. Why this caution in the Treasury's position?

2. *Amount taxable.* Should the taxpayer in the *Rhodes' Estate* case be taxed on $11,925 or on $12,000? If the dividend was sold in one year and paid in another, in which year is the taxpayer taxable? In Gleason v. Commissioner, ¶42,572 P-H Memo T.C., a taxpayer who engaged in this practice was apparently taxed on the amounts received from his assignee in the years the assignments occurred rather than when the dividends were paid:

> He cannot escape or change the tax upon them [the dividends] by any anticipatory arrangement even though he may anticipate the realization of income by means of a transaction which he chooses to call a sale.

What if the taxpayer sells the dividends not in the hope of getting capital gains but solely to realize the income in an earlier year?

3. *Disputed or doubtful claims.* Would the same result as in the principal case be reached if the taxpayer sold a claim for a dividend when the obligor corporation's liability or capacity to pay was uncertain and the transaction was entirely at arm's length?

4. *Bonds with accrued interest.* If a bond is sold between interest dates, the seller must report the accrued interest as income; the buyer treats it as return of capital. Fisher v. Commissioner, 209 F.2d 513 (6th Cir. 1954). (Why are bonds sold between interest dates treated differently from stock sold between dividend dates?) If a taxpayer purchases a bond on which interest is past due, however, a payment of the arrearages is a return of capital (or capital gain to the extent it exceeds his cost); only the interest accruing during his ownership is taxed as ordinary income. Regs. §1.61-7(c). How should a taxpayer who buys a defaulted bond and sells it "flat" (i.e., without allocation between principal, interest due at the time of his purchase, and additional interest accruing during his ownership) treat the lump sum sales price? Jaglon v. Commissioner, 303 F.2d 847 (2d Cir. 1962); see also United States v. Langston, 308 F.2d 729 (5th Cir. 1962) (especially Judge Brown's dissenting opinion).

5. *Other anticipatory transfers.* Twelve days before the maturity of a paid-up endowment policy, the taxpayer sold it to his law partners, reporting the difference between his cost and the sales price as long-term capital gain. Because a surrender of the policy to the issuer at or before its maturity would have produced ordinary income (for want of a "sale or exchange"), the gain on the sale was held taxable as ordinary income in Commissioner v. Phillips, 275 F.2d 33 (4th Cir. 1960); see also First National Bank v. Commissioner, 309 F.2d 587 (8th Cir. 1962). The court in *Phillips* relied primarily on the *Lake* case, without emphasizing the fact that the policy was sold just before its maturity. But would *Lake* preclude a capital gain if the policy lacked a cash surrender value and was sold long before maturity or if, though having a cash surrender value, it was sold before maturity to a buyer who intended to hold it for its long-term appreciation?

5. *Meaning of Term "Property" in §1221*

MILLER v. COMMISSIONER
299 F.2d 706 (2d Cir. 1962)

Before WATERMAN, KAUFMAN and MARSHALL, Circuit Judges.

KAUFMAN, Circuit Judge.

Petitioner is the widow of Glenn Miller, a band leader who achieved world fame about twenty-five years ago. Although Glenn Miller died in 1944, petitioner has been able to engage in a number of enterprises actively exploiting his continuing popularity. Apparently "the good that men do," if sufficiently publicized, does live after them, for petitioner's commercial efforts have met with appreciable financial success.

Thus, in 1952, she entered into a contract with Universal Pictures Company, Inc. (Universal) in connection with the production of a motion picture film entitled "The Glenn Miller Story"; and in the calendar year 1954, she received $409,336.34 as her share of the income derived from that theatrical venture. According to the terms of the 1952 contract, petitioner had purportedly granted to Universal "the exclusive right to produce, release, distribute and exhibit . . . one or more photoplays based upon the life and activities of Glenn Miller throughout the world"; and had warranted that she was "the sole and exclusive owner of all the rights" conveyed by her.

Petitioner now contends that the payment received in 1954 from Universal pursuant to that contract should be considered, for income tax purposes, as a "gain from the sale or exchange of a capital asset held for more than 6 months"; while the Commissioner, whose position was sustained by the Tax Court, contends that the 1954 payment must be treated as ordinary income. That is the difference between the parties, and in terms of taxes allegedly due in this case, it amounts to $159,850.71. Since there is little doubt on the facts presented here that there was a "gain," a "sale or exchange," and a holding "for more than 6 months," the specific question dividing the parties relates to the meaning of the term "capital asset." Furthermore, since Section 1221 of the Internal Revenue Code of 1954 defines the term "capital asset" as "*property* held by the taxpayer . . ." (emphasis supplied), and since, if anything was held by anyone it was held by the petitioner, the conflict is narrowed to the meaning of the word "property" for purposes of this section of the Code.

One would assume that since the question is so easily narrowed, the answer would be correspondingly free of difficulty. The assumption is unwarranted. The narrowing of a question does, ordinarily, reduce the *complexity* of the answer; but it also tends to increase the difficulty of reaching it. Moreover, in order to avoid creating more problems than we resolve, we wish to emphasize

that throughout the ensuing discussion, our analysis of the term "property" is made within the context of capital gains taxation; universality in definition is not only unlikely, but undesirable.

The Internal Revenue Code does not define "property" as used in Section 1221. . . . Therefore, we must look outside the eight corners of the code for some elucidation. The ordinary technique is to refer to principles of state property law for, if not an answer, at least a hint. Since ultimately it is the Congressional purpose which controls, such non-tax definitions are certainly not binding on us. . . . On the other hand, Congress may be presumed to have had ordinary property concepts in mind so they are relevant to our inquiry.

Most people trained in the law would agree that for many purposes one may define "property" as a bundle of rights, protected from interference by legal sanctions. Cf. Restatement, Property, §§1-5. This concept is behind one prong of petitioner's attack. She cites several cases, claiming they indicate that if Universal had made its motion picture without contracting with her, it would have been the victim of a substantial lawsuit.

Even if this were so, those cases would not compel this court to recognize, for income tax purposes, a "property right" in Glenn Miller himself if he were still alive. However, it is not necessary for us to reach a determination upon such an assertion. Those cases do not even remotely bear on the question whether such a property right, if it existed, could pass to the sole beneficiary under his will; and certainly they lend no support to petitioner's theory that the reputation or fame of a dead person could give rise to such "property rights." In fact, in the only case cited in which the rights of a dead man were considered at all, the court held against the claimant. Runyon, Jr. v. U.S., 281 F.2d 590, 592 (5th Cir. 1960). Indeed, petitioner is well aware of this, for she concedes that at the time of the "sale" there were "no *clear-cut* decisions . . . protecting publicity rights of a deceased celebrity . . ." (Pet. Br. p. 43).

Undeterred by her failure to find case authority which would substantiate the existence of "property rights" petitioner invokes the authority of logic. With considerable ingenuity, she argues:

(1) Universal paid petitioner $409,336.34 in 1954, which is a great deal of money.

(2) Universal was a sophisticated corporate being to which donative intent would be difficult to ascribe.

(3) If there was no danger in free use of Glenn Miller material, why did Universal pay?

Petitioner appears to find this question unanswerable unless it is conceded that there was a sale of a "property right." Petitioner is wrong.

It is clear to this Court, at least, that many things can be sold which are not "property" in any sense of the word. One can sell his time and experience, for instance, or, if one is dishonest, one can sell his vote; but we would suppose that no one would seriously contend that the subject matter of such sales is "property" as that word is orinarily understood. Certainly no one would contend that such subject matter was inheritable. We conclude, therefore, that not everything people pay for is "property."

In the instant case, "something" was indeed sold. And the expedient business practice may often be to sell such "things." But the "thing" bought, or more appropriately "bought off," seems to have been the chance that a new theory of "property" might be advanced, and that a lawsuit predicated on it might be successful. It was a purchase, so to speak, of freedom from fear. In effect, it was a hedge against the chance that the Miller "property" might exist. Because Universal feared that it might sometime in the future be held to have infringed

a property right does not mean, however, that a court presently considering whether that property right *did* exist in 1952 must realize Universal's worst fears. That does not mean that Universal's payment was foolish or illusory. It got what it contracted for in 1952 and what it later paid Mrs. Miller for: freedom from the danger that at a future date a defensible right constituting "property" *would* be found to exist. But it didn't pay for "property." [1]

It may be helpful to compare this situation with one which involves the settlement of a tort claim, e.g., a negligence lawsuit. No one doubts the existence of a legal principle creating liability for negligence. If the facts are as a plaintiff contends, and they come within that principle, the defendant's liability exists. Even if they do not, the defendant, for his own reasons, may agree to make a payment in settlement of his alleged liability. Moreover, the Commissioner, for purposes of taxation, may accept that settlement as an implied affirmation that the *facts* were substantially as the plaintiff contended, and treat the recovery accordingly. But no two individuals can, by agreement between themselves, create a *legal* principle, binding upon everyone else, including the Commissioner, where none existed before. This is the exclusive domain of the legislature and the courts as repository of the public will. Admittedly, this court cannot overlook the fact that much of the work of a lawyer is predicting future judicial advances (or aberrations, perhaps); and that is undoubtedly what Universal's lawyers were doing in 1952. But, a lawyer's prediction of the future, as some lawyers know, is not law.

In any event, we are unwilling to accept the fact of substantial payment as proof that "property" within the meaning of Section 1221 of the Code exists; and for the reasons stated, we must reject this argument as being in reality a makeweight. Petitioner conceded that at the time of the "sale" there had been no authoritive decision holding that a decedent's successors had any "property right" to the public image of a deceased entertainer; and therefore it follows that their bargain was not, at that time, a bargain that both parties knew involved a "property right." Furthermore, we do not find it necessary to decide whether the parties were then bargaining for a property right. The case before us only involves the meaning of language in a highly technical statute and the legal effects flowing from that language.

"[I]t is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset . . ." C.I.R. v. Gillette Motor Transport, Inc., 364 U.S. 130, 134 (1960); C.I.R. v. Phillips, 275 F.2d 33, 35 (4th Cir. 1960). Gains which result from the sale or exchange of capital assets receive preferential tax treatment. Therefore, "the definition of a capital asset must be narrowly applied," Corn Products Refining Co. v. C.I.R., 350 U.S. 46, 52; Mansfield Journal Co. v. C.I.R., 274 F.2d 284, 286 (6th Cir. 1960), in order to effectuate the basic Congressional purpose "to relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." Burnet v. Harmel, 287 U.S. at p. 106; Corn Productes Refining Co. v. C.I.R., supra. We do not believe that for income tax computation purposes the beneficiaries of the estate of a deceased entertainer receive by descent a capitalizable "property" in the name, reputation, right of publicity, right of privacy or "public image" of the deceased; or that in this case the petitioner, for tax purposes, owned any "property" which came into existence

1 One must remember that, the techniques of advertising and promotion being what they are, timing is very important and a successful motion for a preliminary injunction made by one who *claims* a "property right" might be as disastrous as a final award of damages. One can easily find wisdom in this payment by Universal without finding that it paid for "property."

after Glenn Miller's death. Therefore, income received by Mrs. Miller from contractual arrangements made by her with Universal dealing with deceased's intangible rights of the nature above specified is "ordinary" income as opposed to capital gain or loss under §1221 of the Internal Revenue Code of 1954.

Affirmed.

NOTE

1. *Basis of the Miller case.* In reaching its decision, did the court decide that Mrs. Miller would have had no claim against Universal under New York law had the motion picture been made without her permission; that until the New York courts or legislatures clearly recognized such a claim, it would not consider it as "property" within the meaning of §1221; or that the extent of her rights under state law is irrelevant? If the opinion is based on the second of these possibilities, how could the taxpayer have established the scope of her rights under New York law?

Mrs. Miller sued Universal for damages arising out of the use by Decca (Universal's parent corporation) of the motion picture sound track in the manufacture of phonograph records. The New York courts held that she did not have "any property interests in the Glenn Miller 'sound' [i.e., the mode of musical rendition employed by the Glenn Miller orchestra]," but that she might have a claim based on breach of contract. Miller v. Universal Pictures Co., Inc., 201 N.Y.S.2d 632 (1960), aff'd per curiam (3 judges dissenting, with opinion), 10 N.Y.2d 972, 180 N.E.2d 298 (1961).

See also Runyon v. United States, 281 F.2d 590 (5th Cir. 1960) (alleged right to privacy not a capital asset).

2. *Payment for use of taxpayer's property.* In Commissioner v. Gillette Motor Transport, Inc., cited in the *Miller* case, the taxpayer claimed that compensation received for the temporary requisition of its facilities by the government during World War II was taxable as capital gain. Although the controlling statutory provision was §117(j) of the 1939 Code (now §1231, infra page 552), the ultimate question (as framed by the Court) was whether the right that was seized by the government was a "capital asset." The Court held that it was not:

> While a capital asset is defined in [§1221] as "property held by the taxpayer," it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. . . .
>
> In the present case, respondent's right to use its transportation facilities was held to be a valuable property right compensable under the requirements of the Fifth Amendment. However, that right was not a capital asset within the meaning of [§§1221 and 1231]. To be sure, respondent's facilities were themselves property embraceable as capital assets under [§1231]. Had the Government taken a fee in those facilities, or damaged them physically beyond the ordinary wear and tear incident to normal use, the resulting compensation would no doubt have been treated as gain from the involuntary conversion of capital assets. See, e.g., *Waggoner,* 15 T.C. 496; *Henshaw,* 23 T.C. 176. But here the Government took only the right to determine the use to which those facilities were to be put.
>
> That right is not something in which respondent had any investment, separate and apart from its investment in the physical assets themselves. Respondent suggests no method by which a cost basis could be assigned to the right; yet it is necessary, in determining the amount of gain realized for purposes of [§1222], to deduct the basis of the property sold, exchanged, or involuntarily converted from the amount received. [§1001(a).] Further, the right is manifestly not of the type which gives rise to the hardship of the realization in one year of an advance in value over cost built up in several years, which is what Congress sought to ameliorate by the capital-gains provisions. . . . In short, the right to use is not a capital asset, but is simply an incident of the underlying physical property, the recompense for which is commonly regarded as rent. [364 U.S. at 135.]

With the first two sentences in the above extract from the *Gillette Motor Transport* case, compare Regs. §1.1221-1(a): "The term 'capital assets' includes all classes of property not specifically excluded by section 1221."

6. *Correlation with Prior Related Transaction*

MERCHANTS NATIONAL BANK v. COMMISSIONER

199 F.2d 657 (5th Cir. 1952)

Before BORAH, STRUM, and RIVES, Circuit Judges.

STRUM, Circuit Judge.

This is a petition to review a decision of the Tax Court which sustained deficiency assessments in petitioner's income taxes for the years 1943 and 1944. . . .

The 1944 deficiency arose from the following facts: On January 1, 1941, the petitioner held notes of Alabama Naval Stores Company, representing loans made by the bank to the Naval Stores Company, on which there was an unpaid balance of $49,025.00. In 1941 and 1943, at the direction of national bank examiners, the bank charged these notes off as worthless, thereafter holding them on a "zero" basis. Deductions for the charge-offs, as ordinary losses, were allowed in full by the Commissioner on petitioner's income tax returns in 1941 and 1943. In 1944, petitioner sold the notes to a third party for $18,460.58, which it reported on its return for 1944 as a long term capital gain and paid its tax on that basis. The Commissioner held this sum to be ordinary income, taxable at a higher rate than long term capital gains, and entered a deficiency assessment accordingly, in which he was sustained by the Tax Court. This is the basis of the 1944 controversy.

The rule is well settled, and this Court has held, that when a deduction for income tax purposes is taken and allowed for debts deemed worthless, recoveries on the debts in a later year constitute taxable income for that year to the extent that a tax benefit was received from the deduction taken in a prior year. Commissioner v. First State Bank of Stratford [infra page 668], cert. denied, 335 U.S. 867 (1948); National Bank of Commerce v. Commissioner, 9 Cir., 115 F.2d 875.

When these notes were charged off as a bad debt in the first instance, the bank deducted the amount thereof from its ordinary income, thus escaping taxation on that portion of its income in those years. The amount subsequently recovered on the notes restores pro tanto the amount originally deducted from ordinary income, and is accordingly taxable as ordinary income, not as a capital gain. When the notes were charged off, and the bank recouped itself for the capital loss by deducting the amount thereof from its current income, the notes were no longer capital assets for income tax purposes. To permit the bank to reduce its ordinary income by the amount of the loss in the first instance, thus gaining a maximum tax advantage on that basis, and then permit it to treat the amount later recovered on the notes as a capital gain, taxable on a much lower basis than ordinary income, would afford the bank a tax advantage on the transaction not contemplated by the income tax laws.

The fact that the bank sold these notes to a third party, instead of collecting the amount in question from the maker of the notes does not avoid the effect of the rule above stated. Nor are the cases just cited distinguishable, as contended by appellant, because in the first the notes were distributed as a dividend in kind, and in the second were received by the taxpayer as part of a non-taxable reorganization. The controlling point in both cases is, as here, that the amount of

the notes was originally deducted from ordinary income, and the owner-bank allowed a tax benefit on that basis, from which premise both courts concluded that the taxpayer should settle on the same basis as to sums subsequently recovered, since those sums stand in place of the income which escaped taxation in the year when the deduction was taken.

As the recoveries in question were ordinary income, not capital gains, the 1944 deficiency was properly entered.

Affirmed.

NOTE

1. *Scope of correlation with prior transaction.* Note the court's reference to "a tax advantage not contemplated by the income tax laws." What if, by reason of changing tax rates or the taxpayer's fluctuating income, reporting the proceeds of the notes in 1944 as ordinary income would produce a tax greater than the tax that was saved by the 1941 and 1943 deductions? If a taxpayer deducts a non-business bad debt as a capital loss under §166(d), can he treat a later recovery on it as capital gain rather than ordinary income even though he has not engaged in a sale or exchange? Is the opinion applicable to a sale of materials and supplies whose cost was deducted on acquisition under §162?

2. *"Recapture" of depreciation deductions.* By virtue of §1245 and §1250, enacted in 1962 and 1964, taxpayers must report a gain on the sale of certain depreciable property as ordinary income, rather than as capital gain, to the extent that the property gave rise to depreciation deductions from ordinary income in prior years. See Section G infra, page 561.

ARROWSMITH v. COMMISSIONER

344 U.S. 6 (1952)

MR. JUSTICE BLACK delivered the opinion of the Court.

This is an income tax controversy growing out of the following facts as shown by findings of the Tax Court. In 1937 two taxpayers, petitioners here, decided to liquidate and divide the proceeds of a corporation in which they had equal stock ownership. Partial distributions made in 1937, 1938, and 1939 were followed by a final one in 1940. Petitioners reported the profits obtained from this transaction, classifying them as capital gains. They thereby paid less income tax than would have been required had the income been attributed to ordinary business transactions for profit. About the propriety of these 1937-1940 returns, there is no dispute. But in 1944 a judgment was rendered against the old corporation and against Frederick R. Bauer, individually. The two taxpayers were required to and did pay the judgment for the corporation, of whose assets they were transferees. [§6901(a)(1)(A).] Classifying the loss as an ordinary business one, each took a tax deduction for 100% of the amount paid. Treatment of the loss as a capital one would have allowed deduction of a much smaller amount. . . . The Commissioner viewed the 1944 payment as part of the original liquidation transaction requiring classification as a capital loss, just as the taxpayers had treated the original dividends as capital gains. Disagreeing with the Commissioner the Tax Court classified the 1944 payment as an ordinary business loss. 15 T.C. 876. Disagreeing with the Tax Court the Court of Appeals reversed, treating the loss as "capital." 193 F.2d 734. This latter holding conflicts with the Third Circuit's holding in Commissioner v. Switlik, 184 F.2d 299. Because of this conflict, we granted certiorari. 343 U.S. 976.

[Section 165(f)] treats losses from sales or exchanges of capital assets as "capital losses" and [§331(a)(1)] requires that liquidation distributions be treated as ex-

changes. The losses here fall squarely within the definition of "capital losses" contained in these sections. Taxpayers were required to pay the judgment because of liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings. It is not even denied that had this judgment been paid after liquidation, but during the year 1940, the losses would have been properly treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains taxpayers received during that year.

It is contended, however, that this payment which would have been a capital transaction in 1940 was transformed into an ordinary business transaction in 1944 because of the well-established principle that each taxable year is a separate unit for tax accounting purposes. United States v. Lewis, 340 U.S. 590; North American Oil v. Burnet, 286 U.S. 417. But this principle is not breached by considering all the 1937-1944 liquidation transaction events in order properly to classify the nature of the 1944 loss for tax purposes. Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.

The petitioner Bauer's executor presents an argument for reversal which applies to Bauer alone. He was liable not only by reason of being a transferee of the corporate assets. He was also held liable jointly with the original corporation, on findings that he had secretly profited because of a breach of his fiduciary relationship to the judgment creditor. Trounstine v. Bauer, Pogue & Co., 44 F. Supp. 767, 773; 144 F.2d 379, 382. The judgment was against both Bauer and the corporation. For this reason it is contended that the nature of Bauer's tax deduction should be considered on the basis of his liability as an individual who sustained a loss in an ordinary business transaction for profit. We agree with the Court of Appeals that this contention should not be sustained. While there was a liability against him in both capacities, the individual judgment against him was for the whole amount. His payment of only half the judgment indicates that both he and the other transferee were paying in their capacities as such. We see no reason for giving Bauer a preferred tax position.

Affirmed.

Mr. Justice Douglas, dissenting.

I agree with Mr. Justice Jackson that these losses should be treated as ordinary, not capital, losses. There were no capital transactions in the year in which the losses were suffered. Those transactions occurred and were accounted for in earlier years in accord with the established principle that each year is a separate unit for tax accounting purposes. See United States v. Lewis [supra page 103]. I have not felt, as my dissent in the *Lewis* case indicates, that the law made that an inexorable principle. But if it is the law, we should require observance of it — not merely by taxpayers but by the Government as well. We should force each year to stand on its own footing, whoever may gain or lose from it in a particular case. We impeach that principle when we treat this year's losses as if they diminished last year's gains.

Mr. Justice Jackson, whom Mr. Justice Frankfurter joins, dissenting.

This problem arises only because the judgment was rendered in a taxable year subsequent to the liquidation.

Had the liability of the transferor-corporation been reduced to judgment during the taxable year in which liquidation occurred, or prior thereto, this problem, under the tax laws, would not arise. The amount of the judgment rendered against the corporation would have decreased the amount it had available for distribution, which would have reduced the liquidating dividends proportion-

ately and diminished the capital gains taxes assessed against the stockholders. Probably it would also have decreased the corporation's own taxable income.

Congress might have allowed, under such circumstances, tax returns of the prior year to be reopened or readjusted so as to give the same tax results as would have obtained had the liability become known prior to liquidation. Such a solution is foreclosed to us and the alternatives left are to regard the judgment liability fastened by operation of law on the transferee as an ordinary loss for the year of adjudication or to regard it as a capital loss for such year.

This Court simplifies the choice to one of reading the English language, and declares that the losses here come "squarely within" the definition of capital losses contained within two sections of the Internal Revenue Code. What seems so clear to this Court was not seen at all by the Tax Court, in this case or in earlier consideration of the same issue; nor was it grasped by the Court of Appeals for the Third Circuit. Commissioner v. Switlik, 184 F.2d 299 (1950).

I find little aid in the choice of alternatives from arguments based on equities. One enables the taxpayer to deduct the amount of the judgment against his ordinary income which might be taxed as high as 87%, while if the liability had been assessed against the corporation prior to liquidation it would have reduced his capital gain which was taxable at only 25% (now 26%). The consequence may readily be characterized as a windfall (regarding a windfall as anything that is left to a taxpayer after the collector has finished with him).

On the other hand, adoption of the contrary alternative may penalize the taxpayer because of two factors: (1) since capital losses are deductible only against capital gains, plus $1,000, a taxpayer having no net capital gains in the ensuing five years would have no opportunity to deduct anything beyond $5,000; and (2) had the liability been discharged by the corporation, a portion of it would probably in effect have been paid by the Government, since the corporation could have taken it as a deduction, while here the total liability comes out of the pockets of the stockholders.

Solicitude for the revenues is a plausible but treacherous basis upon which to decide a particular tax case. A victory may have implications which in future cases will cost the Treasury more than a defeat. This might be such a case, for anything I know. Suppose that subsequent to liquidation it is found that a corporation has undisclosed claims instead of liabilities and that under applicable state law they may be prosecuted for the benefit of the stockholders. The logic of the Court's decision here, if adhered to, would result in a lesser return to the Government than if the recoveries were considered ordinary income. Would it be so clear that this is a capital loss if the shoe were on the other foot?

Where the statute is so indecisive and the importance of a particular holding lies in its rational and harmonious relation to the general scheme of the tax law, I think great deference is due the twice-expressed judgment of the Tax Court. In spite of the gelding of Dobson v. Commissioner, 320 U.S. 489, by the recent revision of the Judicial Code, Act of June 25, 1948, §36, 62 Stat. 991-992, I still think the Tax Court is a more competent and steady influence toward a systematic body of tax law than our sporadic omnipotence in a field beset with invisible boomerangs. I should reverse, in reliance upon the Tax Court's judgment more, perhaps, than my own.

NOTE

1. *Applications of Arrowsmith doctrine.* A taxpayer sold real property, reporting a capital gain on the transaction. Several years later the vendees discovered that the building encroached on the land of a third party and paid $3000 to relocate it. The tax-

payer, who had sold the property by warranty deed, reimbursed the vendees for this expense and sought to deduct it as an ordinary loss. The Tax Court held that only a capital loss could be taken, since the "adjustment under the warranty was a part and parcel of the sale of the property," on which capital gain rather than ordinary income was realized. Estate of Shannonhouse v. Commissioner, 21 T.C. 422 (1954). See also Machris' Estate v. Commissioner, 34 T.C. 827 (1960) (on sale of corporate stock, sellers were to get specified amount plus additional amounts dependent on subsequent determination of oil reserves on corporation's property; held, expenses of engineering surveys to establish amount of reserves, to extent paid by sellers under agreement, constituted long-term capital loss, not an expense under §162 or §212); Wener v. Commissioner, 242 F.2d 938 (9th Cir. 1957) (partners sold their partnership interests for $75,000, of which $15,000 was paid in cash and $60,000 was evidenced by notes, and deducted as a loss the difference between their basis for the interests and $75,000; at a later date, they accepted $35,000 in full settlement of the notes; held, difference between face amount of notes and $35,000 was a long-term capital loss under *Arrowsmith*); Note, Tax Treatment of Stockholder-Transferees' Payments in Satisfaction of Dissolved Corporations' Unpaid Debts, 61 Yale L.J. 1081 (1952).

If the taxpayer engages in a tax-free exchange (e.g., under §1031) and later makes a payment to the transferee because the transferred property did not meet its specifications, does he have an ordinary loss, a capital loss, or an adjusment to the basis of the property received in the exchange? See Rees Blow Pipe Mfg. Co. v. Commissioner, 41 T.C. No. 58 (1964).

2. *Impact of §1341.* Would the result in *Arrowsmith* have been changed if §1341 had been in effect for the taxable year in question? See, for §1341, page 104 supra.

3. *Expenses of realizing capital gain.* Does *Arrowsmith* afford a basis for requiring the taxpayer to treat business expenses as capital losses if they are incurred in realizing capital gains? (This treatment is imposed on selling expenses, in effect, by requiring them to be offset against the sales proceeds, supra page 460.)

SECTION D. PROPERTY HELD FOR SALE TO CUSTOMERS

Section 1221(1), relating to property held for sale to customers, is a re-enactment of §117(a)(1)(A) of the 1939 Code.

VAN SUETENDAEL v. COMMISSIONER

¶44,305 P-H Memo T.C. (1944)

MEMORANDUM FINDINGS OF FACT AND OPINION

HARRON, Judge: . . .

During the taxable years, and for some years prior thereto, the petitioner was primarily engaged in buying and selling securities. Approximately 90 per cent of the securities purchased by him were interest-bearing bonds and the other 10 per cent consisted of preferred and common stock. His income was derived principally from interest on the bonds purchased and from interest on bank deposits. He maintained an office in Yonkers and had one employee who acted as his secretary-typist and general assistant. He was not a member of any stock exchange. His name was listed in several statistical financial publications as a dealer in securities, and in the Yonkers city and telephone directories under the classification of "investments." He also listed offerings to buy or sell securities at a certain price in the National Daily Quotation Service, for which he paid an annual subscription fee. This service was circularized among investment and trading houses in the United States. Petitioner has registered with the Securities and Exchange Commission, the State of New York, and the Bureau of Internal Revenue as a broker or dealer in securities. From time to time he has advertised in a Yonkers

newspaper offering to buy or sell certain securities. Occasionally, his name appeared in the advertising section of the Columbia Alumni News under the caption "Investment Securities." He has also written to individuals, banks, and insurance companies offering securities at stated prices. Over a period of years, he has occasionally distributed calendars and pocket manuals containing data on securities of companies listed on the leading stock exchanges. Prior to the taxable years, petitioner, to a small degree, had participated in selling groups for the purpose of distributing new issues of securities. . . .

During the taxable years, petitioner maintained separate accounts with Eastman, Dillon & Company, Ira Haupt & Company, and Chisholm & Chapman, all of whom were brokers, having membership on the New York Stock Exchange and the New York Curb Exchange. The great proportion of the securities sold by the petitioner during these years were sold to or through Eastman, Dillon & Company and Ira Haupt & Company. Excluding sales to petitioner's wife and son, approximately 77 per cent of petitioner's total sales in these years were made to or through Eastman, Dillon & Company and Ira Haupt & Company. Some of the securities purchased by petitioner from these brokers were kept by them for petitioner. Many of the specific securities sold to or through Eastman, Dillon & Company and Ira Haupt & Company had been previously purchased by petitioner from these same brokers. . . .

In reporting the transactions of the sales of securities in each year on his return, petitioner took the view that all of the securities sold were non-capital assets, so that he computed the result of all the transactions in each year simply by taking the total cost of the securities and the total receipts from sales. . . .

The respondent, in determining the deficiencies, held that the securities sold by petitioner were capital assets, and he therefore applied the limitations of [§1211(b)] in computing petitioner's net income from the sale of such securities.

Opinion

In this proceeding, as well as in a former proceeding before the Board of Tax Appeals involving prior taxable years, the petitioner has attempted to show that he was recognized in the security trade as a dealer in securities. He has placed great emphasis on the fact that he had registered with the Securities and Exchange Commission and the State of New York as a security dealer. Similarly, he has pointed to advertisements placed by him in newspapers, bulletins, and pamphlets indicating that he dealt in securities during the taxable years. On brief, he argues that the entire case resolves itself to the one question of whether he was engaged in business as a dealer in securities. That, however, is not the issue. The phrase "dealer in securities" is not defined in the statute, although it is defined in [Regs. §1.471-5]. The only issue for determination here is whether the securities sold by petitioner during the taxable years were capital assets under [§1221].

Under [§1221], all property is to be treated as capital assets unless the taxpayer is able to bring himself within one of the stated exceptions in the definition of capital assets. As far as this proceeding is concerned, the only possible exceptions which petitioner could rely upon are that the securities sold were

> stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

The securities which petitioner sold during the taxable years cannot be classified as stock in trade or property subject to inventory in his hands unless they were held by him primarily for sale to customers in the ordinary course of his business. Thus, the issue turns on whether or not the securities sold by petitioner during the taxable years were held by him primarily for sale to customers in the ordinary course of business. This is probably the reason why petitioner has placed such stress upon the contention that he was a dealer in securities since securities in the nature of stock in trade held primarily for sale to customers are held only by dealers in securities. See Francis Shelton Farr, 44 B.T.A. 683. However, there may be many sales of securities by so-called dealers in securities which do not come within the exceptions set forth in the definition of capital assets. The fact that petitioner had a teletype machine, four telephones and statistical financial publications in his office, was listed as a "dealer" in certain publications, and advertised himself as willing to buy or sell securities is not determinative of the issue. The subject matter of the cited sections is property and it must be shown that the property itself comes within the exceptions stated in the definition of capital assets.

The respondent has determined that the securities sold by the petitioner during the taxable years were not held by him primarily for sale to customers in the ordinary course of his business. The burden of proving otherwise is upon petitioner. The question is predominantly one of fact. . . .

From an analysis of the schedule showing all of petitioner's transactions in securities during these years, we cannot find as a fact that petitioner held the securities sold by him during the taxable years primarily for sale to customers in the ordinary course of his business. The facts are just as consonant with the theory that petitioner held the securities for speculation or for investment. It is well established that taxpayers who buy securities for speculation or investment hold them as capital assets and not primarily for resale to customers. Seeley v. Helvering, 77 F.(2d) 323; O. L. Burnett, 40 BTA 605, affirmed on point considered here, 118 F.(2d) 659; Vaughan v. Commissioner, 85 F.(2d) 497, certiorari denied, 299 U.S. 606. One who holds securities in the nature of stock in trade primarily for resale to customers is regularly engaged in the purchase of securities at wholesale. Francis Shelton Farr, supra. He is a middleman in distributing the securities and he does not resell to the same class of persons from whom he buys. Seeley v. Helvering, supra. Here, petitioner did not make wholesale purchases of securities. The securities purchased were in relatively small quantities and were diversified. In this respect, he acted no differently from an ordinary purchaser. Most of the securities purchased by petitioner were resold to or through the same brokers from whom they were bought. Here again, petitioner acted in the same manner as an ordinary purchaser having an account with a broker. Approximately 77 per cent of all the securities sold by petitioner during the taxable years, excluding those sold to his wife and son, were sold to or through Eastman, Dillon & Company and Ira Haupt & Company. In most of these transactions, the companies acted as brokers and did not purchase the securities as principals for their own account. These brokers or their clients cannot be considered as petitioner's customers. Francis Shelton Farr, supra; Seeley v. Helvering, supra; Vaughan v. Commissioner, supra. Over 92 per cent of the securities sold by petitioner to or through Eastman, Dillon & Company and Ira Haupt & Company had been previously acquired by him from the same two brokerage houses. Many of these securities were resold by petitioner at a profit on the same day on which he purchased them or a short time thereafter. Obviously, in those cases, he never actually received the securities since the brokers who purchased

and sold them for him were the same. The result of those transactions was that petitioner merely received or was credited with the profit. In this respect, his operations were similar to a trader purchasing securities on margin. Petitioner could not have intended to purchase these securities for resale to "customers" as that word is used in the statute. Some of the securities purchased through the two brokerage houses were not delivered to petitioner, but were kept by the brokers. It may be that they were retained as collateral for loans, which would be another indication that petitioner was purchasing and holding the securities for speculation. Our analysis of these schedules, together with the record as a whole, warrants the conclusion that the securities purchased by petitioner were not held as stock in trade primarily for resale to customers. Although petitioner did make efforts to sell some of the securities through channels other than brokers and dealers, and actually did sell a small amount of the securities to other parties, we cannot find even as to those securities that they were purchased primarily for resale to customers. A mere statement in behalf of petitioner that they were purchased or held for that purpose is insufficient. Vaughan v. Commissioner, supra. We think that the purchases and sales of all of the securities were engendered by the speculative advantage which might be derived by petitioner, or the income which he might receive therefrom.

Respondent points out that during the taxable years, petitioner's principal source of income was derived from interest on the bonds owned by him and that the great proportion of his losses resulted from securities which he had held for a long period of time. He argues that petitioner, during each of the taxable years, selected securities which he had held for a long time and which were then unprofitable to him and disposed of those securities at the best possible price to anyone who would buy them in order that the loss sustained thereon should offset his income from the interest-bearing bonds held by him. The facts indicate that petitioner received interest on bonds in 1936 in the amount of $25,012; in 1937 in the amount of $27,120.23; and in 1938 in the amount of $31,683.25. During the same period, petitioner reported on his income tax returns, business losses in substantially the same amounts. The facts also show that in 1936, of the total losses of $35,796.68 sustained by petitioner from the sale of securities, $32,659.67 was sustained on securities held by him for more than five years. In 1937, of the total losses of $37,660.91 sustained by petitioner, $16,096.34 was sustained from securities held more than five years. In 1938, of the total losses of $25,806.13 sustained by petitioner, the amount of $21,441.41 was a long-term loss sustained on securities held for more than 18 months. Respondent also argues that as to the securities held for a long period, petitioner did not hold them for resale to customers, but for the income which he might derive therefrom. The facts apparently support respondent's contentions. Respondent also states in his brief that in all of the years since 1929, petitioner has reported substantial income from interest and dividends, yet, in all of these years, his sales of securities have resulted in substantial annual losses which were offset against his income. There appears to be ground for this statement. See Achille O. Van Suetendael, ¶40,269 P-H Memo BTA. . . .

A careful study of the whole record, including all of the exhibits in evidence, convinces us that petitioner has not sustained the burden of proof imposed upon him of showing that the securities sold during the taxable years were held by him primarily for sale to customers in the ordinary course of his business. The proof is just as susceptible of a construction that some of the securities were acquired and held by petitioner for speculation and some for investment. We think that a reasonable conclusion from all of the facts is that petitioner intended to sell the securities in any way he could and to any purchaser regardless of whether or not

the purchaser could be deemed a "customer" within the meaning of the statute. It is therefore held that the securities sold by petitioner during the taxable years were capital assets and subject to the limitations of gain and loss set forth in [§1211(b)]. Respondent's determination is sustained.

NOTE

1. *"Traders" and "dealers."* The Tax Court's decision was affirmed per curiam, Van Suetendael v. Commissioner, 152 F.2d 654, 654 (2d Cir. 1945):

> This issue was predominantly one of fact and the Tax Court's finding was adverse to the taxpayer. We cannot say that "the Tax Court's inferences and conclusions on this factual matter are so unreasonable from an evidentiary standpoint as to require a reversal of its judgment." . . . [W]ith respect to some of the securities sold the taxpayer may have been a dealer and with respect to others a trader, investor or speculator. In his returns he made no attempt to distinguish one sale from another; nor did he present sufficient evidence to enable the Tax Court to do so.

In Commissioner v. Burnett, 118 F.2d 659 (5th Cir. 1941), a leading case in this area, it was held that a "trader" in securities and commodities, whose trading averaged over $10,000,000 per year, did not hold these assets "primarily for sale to customers in the ordinary course of his trade or business."

See also Smith v. Commissioner, 33 T.C. 465, 482 (1959), holding that commodities and commodities futures were capital assets despite the fact that the taxpayer was a business enterprise (an association taxable as a corporation) whose sole business activity was commodity trading.

Should a "trader" in securities be treated differently from a dealer, either when he has gains or when he suffers losses?

The requirement that property, to avoid capital asset treatment, be held for sale "to customers" came into the statute in 1934. It was designed to prevent "a stock speculator trading on his own account" from claiming ordinary losses on his transactions and thus canceling out his income from dividends, interest, etc. by what were apparently thought by Congress to be frequently fictitious transactions, H.R. Rept. No. 1385, 73d Cong. 2d Sess., 1939-1 C.B. (Part 2) 627, 632; Wood v. Commissioner, 16 T.C. 213, 219-220 (1951). In enacting the restriction, Congress seems to have overlooked the possibility that, in another part of the business cycle, "traders" might realize profits and would be able to report them as capital gains.

In retrospect, the 1934 amendment may appear superfluous; in 1941, the Supreme Court refused to upset a determination by the Tax Court that a wealthy investor's activities in managing his own estate did not constitute a "trade or business" under §162(a), and it would not stretch the reasoning of the opinion to interpret it as also meaning that his securities were not held for sale "in the ordinary course of trade or business" within the meaning of §1221(1). Higgins v. Commissioner, supra pages 204-205. To be sure, the taxpayer in *Higgins* was interested in long-term investments rather than in short-run trading profits, but his investments were worth over $25 million and required the attention of a regular office staff; the approach of the case strongly suggests that even a trader like Van Suetendael is not engaged in a "trade or business." The question cannot be considered as closed, however, since some courts recognize, in applying §162, the "business of trading in securities." See Main Line Distributors, Inc. v. Commissioner, 321 F.2d 562 (6th Cir. 1963), and cases there cited; Commissioner v. Levis' Estate, 127 F.2d 796 (2d Cir. 1942), cert. denied, 317 U.S. 645.

Are securities held by a "promoter" (as that term is used in the *Whipple* case, supra page 285) embraced by §1221(1)? See Katz v. Commissioner, ¶60,200 P-H Memo T.C. (stock of corporations owning luncheonettes held for sale to customers in ordinary course of business; the profits on sale of stock represented remuneration for the shareholders' activities in creating and promoting the luncheonette businesses).

2. *"Investment" securities held by dealers.* A dealer in securities may hold some of his securities in an "investment account" rather than for sale and thus qualify them as capi-

tal assets. Carl Marks & Co. v. Commissioner, 12 T.C. 1196 (1949). Section 1236, added by the Revenue Act of 1951, requires such investment securities to be clearly identified as such, to prevent the taxpayer from claiming capital asset treatment if they are sold at a profit, but non-capital treatment if a loss is incurred. A dealer may not treat a security as a capital asset unless it was "clearly identified" in his records as held for investment within thirty days after its acquisition; even if so identified, it will lose its capital asset status if in fact it is held for sale. If the dealer has failed to label a security as held for investment, will the ordinary income taint run with the property if he gives it to his wife or child and the donee sells it? By virtue of §1236(b), once a security has been identified as held for investment, any loss on a subsequent sale or exchange by the dealer will be a capital loss; the security cannot be effectively transferred to the category of property held for sale to customers.

See also Frank v. Commissioner, 321 F.2d 143 (8th Cir. 1963) (taxpayers subscribed to shares of insurance company stock in connection with promotional and sales activities conducted for the company through taxpayers' corporation; held, profit on sale of taxpayers' own shares is taxable as ordinary income, not capital gain).

There is no statutory counterpart of §1236 requiring other types of property to be formally labeled if a dealer wants to distinguish between property held for sale and property of a similar character held for investment. For instances in which dealers have successfully established that they held property for investment, see United States v. Bondurant, 245 F.2d 265 (6th Cir. 1957) ("investment" cotton held by dealer in cotton); Eline Realty Co. v. Commissioner, 35 T.C. 1 (1960) (undeveloped strip of subdivided tract held as investment by real estate dealer). In Stefka v. United States, 2 A.F.T.R.2d 5538 (W.D. Tex. 1958), a partnership engaged in cotton farming reported income at the prevailing market price when the cotton was harvested and then stored it for a time and treated any subsequent profit or loss as capital gain or loss; this practice was upheld, but without opinion. Could a persuasive opinion have been written?

3. *Is §1221(1) repetitious?* In *Van Suetendael,* the court says that the taxpayer's securities "cannot be classified as stock in trade or property subject to inventory in his hands unless they were held by him primarily for sale to customers in the ordinary course of his business." Does this imply that "stock in trade" is no different from "inventory property" and that both coincide completely with "property held for sale to customers" — with the result that §1221(1) embraces not two or three categories of property, but only one? In Gilbert v. Commissioner, 56 F.2d 361 (1st Cir. 1932), the court denied that §1221(1) was redundant, and held that shares of stock received by a construction company as compensation were held for sale in the ordinary course of business (the term "to customers" has not yet been added to the statute) even though they were not "stock in trade" or "inventory property." The Regulations provide that the taxpayer's inventory "should include all finished or partly finished goods and, in the case of raw materials and supplies, only those which have been acquired for sale or which will physically become a part of merchandise intended for sale. . . ." Regs. §1.471-1. Is this provision applicable not only to §471 (use of inventories in determining income) but also to §1221(1)? If a business sells an excess stock of supplies that were not to be physically incorporated in its merchandise (e.g., office supplies, cleaning materials, or repair parts for machinery), do they come within §1221(1)? Should the fact that their cost was deducted (from ordinary income) as a business expense be relevant in determining whether a sale produces ordinary income or capital gain? See Merchants' National Bank v. Commissioner, supra page 531.

Section 1221(1) speaks of property which would be includible in inventory "if on hand at the close of the taxable year." Does this afford an alternative route to the result reached by the Supreme Court in the *Corn Products* case?

4. *Unvarying treatment of §1221(1) property.* As will be seen, some types of property, though they do not constitute "capital assets," receive capital gain or loss treatment in special circumstances. Property that falls under §1221(1), however, is never so treated; it always gives rise to ordinary income or loss.

5. *Accounts receivable.* Note that §1221(4) takes accounts receivable arising on the sale of inventory property out of the capital asset category. See page 573 infra.

MAULDIN v. COMMISSIONER

195 F.2d 714 (10th Cir. 1952)

Before HUXMAN, MURRAH and PICKETT, Circuit Judges.

MURRAH, Circuit Judge.

This is an appeal from a decision of the Tax Court, holding that certain lots sold by petitioners during the taxable years 1944 and 1945, were "property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business" within the exclusionary clause of [§1221(I)]. If a gain from the sale of these lots was derived in this manner, it constituted ordinary income taxable under [§61(a)], and not a capital gain taxable under [§1221 (1)]. Petitioners, residents of the State of New Mexico, are husband and wife, and all income involved is community income. . . .

C. E. Mauldin, a graduate veterinarian since 1904, who also engaged in some road contracting, moved to Albuquerque, New Mexico in 1916, where he organized a road construction company. While in Clovis, New Mexico in 1920, to bid on a sewer project, he decided to move there and engage in the cattle business. Later in the same year, he contracted to buy 160 acres of land one-half mile from the city limits of Clovis for $20,000.00. This land was particularly suitable for cattle feeding, but was not at that time considered suitable for residential development, because the City, with a population of 5000, was not growing in that direction.

By the time Mauldin finally received title to the land in June 1921, he decided that it was not the time to go into the cattle business because of drought, crop and bank failures, and a decline in the cattle business which continued through 1924. He tried to sell the entire tract in 1924 for less than he paid for it, but was unable to do so, partly because a highway had been surveyed diagonally across the land, splitting it into two tracts and rendering it less suitable for cattle feeding. A real estate agent with whom he listed the property for sale advised him that they would have better success if he divided it into small tracts and blocks. The land was accordingly platted into 29 tracts and 4 blocks containing 88 lots each, and called the "Mauldin Addition." At the time the land was platted in 1924, there was still no demand for residential property in the area. In 1927, he built a home for himself near the center of the Addition.

There were no sales of any consequence until the land commenced to be included in the city limits of Clovis in 1931. By 1939, it was wholly within the city limits, and without Mauldin's request, the City began a paving program in the area, for which he was assessed approximately $25,000.00. When he was unable to pay this assessment, the City instituted suits on its paving liens, and in order to save his property, he divided some additional tracts into lots and devoted most of his time to the sale of the lots in the Addition. He listed the property with real estate agents and otherwise promoted sales through personal solicitations, signs, newspaper advertisements, and gifts of lots to a school and the builder of the first F.H.A. house in Clovis. He stated that at times he would "chase" a prospective purchaser "around the block." During 1939 and 1940, he sold enough lots to liquidate the paving indebtedness.

Mauldin testified that with the indebtedness to the City paid, he decided to hold the remaining portions of the original tract for investment purposes, and after 1940, did nothing to promote sales. He stated, "I cut it up and tried my best to sell it to clear it, and when I cleared it, I quit." From 1940 until 1949, when his health failed, Mauldin devoted full time to the lumber business he organized in 1939. During this period, he had no real estate office, no license to

sell real estate, did not advertise the properties by newspapers or signs, had no fixed price for lots, and at times refused to sell certain lots, either because the prospective purchaser would not pay the asked price, or Mauldin did not wish to sell the particular property at that time. The only real estate purchased by Mauldin after acquiring the 160 acres in 1920 was one "unsightly" block of lots near his residence, and some commercial properties to be used in connection with his lumber business.

Due primarily to the location of war facilities nearby, the City of Clovis grew in population to 14,000 in 1940 and to 20,000 to 25,000 in 1945, and the lots in Mauldin Addition were in great demand. By the end of 1945, Mauldin had disposed of all but 20 acres of his original 160 acre tract. This 20 acres was considered by him and real estate dealers to be his most valuable property. Mauldin's records show that he sold 2 lots in 2 transactions in 1941; 11 in 1942 in 2 transactions (6 lots were given to his daughter as a wedding present); 5½ in 1943 in 3 transactions; 5½ in 1944 in 3 transactions; 44½ in 1945 in 15 transactions; 39 in 1946, 1 in 1947 and 2 in 1948. For the taxable years in 1939 and 1940, the taxpayers' income tax returns showed income from real estate only; for each of the years 1941 and 1944 (returns for 1942 and 1943 not shown) they showed net income of approximately $3,000.00 from sales of real estate and approximately $12,000.00 from the lumber business; for the year 1945, $20,484.84 from real estate and $12,339.80 from lumber; and in 1946, $21,942.88 from real estate and $25,005.07 from lumber. On his 1940 return, Mauldin stated that the nature of his business was "real estate"; in 1943 it was shown as "lumber business"; in 1944 he did not designate the nature of his business; and in 1945 it was shown as "lumber and real estate."

In their income tax returns for the years 1944 and 1945, petitioners showed the lots sold during those years as long-time capital assets, and computed the tax accordingly. The Commissioner determined that the profit realized was ordinary income within the meaning of [§1221(1)], and assessed the additional tax. This appeal is from the judgment of the Tax Court sustaining the Commissioner, and the only question is whether its judgment on these facts can be said to be clearly erroneous.

It is admitted by taxpayer that during 1939 and 1940, he was engaged in the business of selling the tracts and lots in Mauldin Addition. He earnestly contends, however, that after 1940, his business status was changed; that his full time thereafter was devoted to the lumber business, and [he] held the remaining lots for investment purposes, selling them only through unsolicited offers when the price was right.

There is no fixed formula or rule of thumb for determining whether property sold by the taxpayer was held by him primarily for sale to customers in the ordinary course of his trade or business. Each case must, in the last analysis, rest upon its own facts. There are a number of helpful factors, however, to point the way, among which are the purposes for which the property was acquired, whether for sale or investment; and continuity and frequency of sales as opposed to isolated transactions. Dunlap v. Oldham Lumber Co., 5 Cir., 178 F.2d 781; Annot. 106 A.L.R. 254; Mertens, Vol. 3, Sec. 22.08. And, any other facts tending to indicate that the sales or transactions are in furtherance of an occupation of the taxpayer, recognizing however that one actively engaged in the business of real estate may discontinue such business and simply sell off the remnants of his holdings without further engaging in the business. Snell v. Commissioner, 5 Cir., 97 F.2d 891. Thus, where residents of New York bought land in Florida and elsewhere from time to time for investment, a part of which was platted and improved, it was held that the occasional sale of lots through local brokers was

not sufficiently frequent or engrossing to give the taxpayers the vocation of real estate dealers. Phipps v. Commissioner, 2 Cir., 54 F.2d 469. And, in Foran v. Commissioner, 5 Cir., 165 F.2d 705, a taxpayer admittedly engaged as a broker of nonproducing oil and gas leases and royalties purchased a producing property which he sold within eighteen months. The profit realized therefrom was held to be income from a long-time capital asset, the court reasoning that since this was the first producing property purchased by the taxpayer, there was no occasion to disbelieve his statement that he acquired it for investment or his motive for selling it.

On the other hand, sale and exchange of lots in 1939 and 1940 from a 92 acre tract of land, partially subdivided in 1932, was held to be in the ordinary course of business where the taxpayer had been continuously engaged in the real estate business since 1908, and had divided a part of the tract into lots in order to facilitate the sale of the land. Gruver v. Commissioner, 4 Cir., 142 F.2d 363. So too was the sale of lots from a tract of land which had been originally purchased for and used as a lettuce farm, but subdivided into lots when it became too valuable for truck farming operations. Richards v. Commissioner, 9 Cir., 81 F.2d 369, 106 A.L.R. 249. See also Oliver v. Commissioner, 4 Cir., 138 F.2d 910. And, lots sold through sales agencies after reacquisition at a trustee's sale, were held to be in the ordinary course of trade or business, as against the contention that they were sold in furtherance of an orderly liquidation in Ehrman v. Commissioner, 9 Cir., 120 F.2d 607. While the purpose for which the property was acquired is of some weight, the ultimate question is the purpose for which it was held. Rollingwood Corp. v. Commissioner, 9 Cir., 190 F.2d 263.

Admittedly, Mauldin originally purchased the property for purposes other than for sale in the ordinary course of trade or business. When, however, he subdivided and offered it for sale, he was undoubtedly engaged in the vocation of selling lots from this tract of land at least until 1940. As against his contention that he ceased to engage in the business after 1940, the record evidence shows that he sold more lots in 1945 on a sellers market without solicitation than he did in 1940 on a buyers market. It seems fairly inferable from the record that at all times he had lots for sale, and that the volume sold depended primarily upon the prevailing economic conditions, brought on by wartime activities and their aftermath. It is true that he was in the lumber business, but his returns plainly show that a substantial part of his income was derived from the sale of the lots. In these circumstances, we cannot say that the Tax Court's conclusions are without factual basis.

The decisions are affirmed.

NOTE

1. *Real estate "dealers."* Compare this taxpayer with the taxpayer in Van Suetendael v. Commissioner. Is there any reason of policy why one should realize ordinary income and losses on his transactions while the other has capital gains and losses? If the persons to whom Mr. Mauldin sold his land were "customers," as that term is used in §1221(1), why were not the persons who bought securities from Mr. Van Suetendael also "customers"? Neither taxpayer had a "clientele" of the kind enjoyed by a department store or other dealer in merchandise. In Black v. Commissioner, 45 B.T.A. 204 (1941), it was stated that for a taxpayer regularly engaged in the business of buying and selling real estate, "any person who can be found to buy such property is a customer." This seems to mean that as respects real estate, the term "to customers" adds nothing to the statutory requirement that the property be held "primarily for sale . . . in the ordinary course of his trade or business." It has already been pointed out, supra page 539, that the phrase "to customers" may have been an unnecessary precaution in the case of traders

or speculators in stock. Does a seller of building lots have "customers" if he sells exclusively to a related corporation which builds houses on the lots to the order of *its* customers? Yes, according to Kaltreider v. Commissioner, 255 F.2d 833 (3d Cir. 1958).

As *Mauldin* indicates, it has not been easy to distinguish real estate held for sale from real estate held for investment. Fink, "Dealing" in Real Estate, 2 Tax L. Rev. 111 (1946), cites many of the cases, and there have been more since 1946; among others, see Friend v. Commissioner, 198 F.2d 285 (10th Cir. 1952); Gamble v. Commissioner, 242 F.2d 586 (5th Cir. 1957); Tidwell v. Commissioner, 298 F.2d 864 (4th Cir. 1962).

If the taxpayer employs an agent to advertise, promote, and sell a subdivided tract, the agent's activities are imputed to him. But what if he offers to sell the lots to a real estate dealer (or to the dealer's customers) at fixed prices, under an arrangement providing that the dealer will defray all development and sales expenses and will derive his profit from selling the lots at whatever prices he can obtain? What if the amount to be paid to the taxpayer is to vary with the prices charged, or the profits realized, by the dealer? See Fishback v. United States, 215 F. Supp. 621 (D.S.D. 1963), and cases there cited; Fahs v. Crawford, 161 F.2d 315 (5th Cir. 1947); Voss v. United States, 329 F.2d 164 (7th Cir. 1964) (owner of farm land authorized real estate dealer to arrange for subdividing and selling property, for a fee; held, capital gain).

In determining the character of gain or loss on the sale or lapse of an option to buy or sell property, §1234 looks to the character which the property to which the option relates has or "would have" in the hands of the taxpayer. If the taxpayer acquires an option to buy a large tract of real estate and realizes a gain (or loss) on selling the option, does the character of his gain or loss depend upon whether he would have become a dealer in building lots if he had exercised the option?

2. *The statutory rules of §1237.* See §1237, added in 1954. What is the significance of its basic principle that qualifying property "shall not be deemed to be held primarily for sale to customers in the ordinary course of trade or business at the time of sale solely because of the taxpayer having subdivided" the tract, etc.? If there are other factors pointing to a trade or business, is §1237 inapplicable? May the fact of subdividing a tract be regarded as a persuasive factor, even though it is not the sole reason for denying capital gain or loss treatment? On these questions, see Regs. §1.1237-1(a)(1)-(3); Hvidsten v. United States, 185 F. Supp. 856 (D.N.D. 1960). The Regulations go on to provide that §1237 is not the exclusive route to capital gains on subdivided realty. Regs. §1.1237-1(a)(4).

3. *Corporation as intermediary.* Suppose Mr. Mauldin organized a corporation, transferred one of the lots to it in exchange for its stock, and then sold the stock. His profit would be the difference between (a) his basis for the stock (which, as is seen infra page 633, would be the same as the basis of the land transferred to the corporation) and (b) the sales price, which presumably would be about the same as the value of the land itself. Would this profit be capital gain? Would he be a "dealer" in the shares of realty corporations? Section 341, which will be met again, expressly provides that the profit on certain transactions of this type is ordinary income, despite the fact that ordinarily the profit on a sale of stock is capital gain. Even without this elaborate statutory provision, the transfer of the real property to the corporation might be disregarded as a sham. Jacobs v. Commissioner, 224 F.2d 412 (9th Cir. 1955). What are the taxpayer's prospects for converting some of the lots into capital assets by giving them to members of his family? Bittker, Charitable Gifts of Income and the Internal Revenue Code: Another View, 65 Harv. L. Rev. 1375, 1385-1388 (1952).

4. *References.* Pennell, Capital Gains in Real Estate Transactions, 1959 Tulane Tax Inst. 23; Weithorn, Subdivisions of Real Estate — "Dealer" v. "Investor" Problem, 11 Tax L. Rev. 157 (1956); Groh, Tax Problems in Real Estate, 36 Taxes 267 (1958).

HOLLIS v. UNITED STATES

121 F. Supp. 191 (N.D. Ohio, 1954)

McNAMEE, District Judge.

In this action . . . plaintiffs seek to recover $4,502.61 with interest, on the

ground that the Commissioner of Internal Revenue erroneously assessed and collected this amount as income tax for the year 1949.

The issue presented is whether oriental art objects sold by the partnership of Hollis & Company were capital assets or property held primarily for sale to customers in the ordinary course of business within the meaning of [§1221(1)]. . . .

The facts are not in dispute but are unique and merit a somewhat extended statement. Howard Hollis was Curator of Far Eastern and Near Eastern Art at the Cleveland Museum of Art from 1929 through 1948. He is one of the leading authorities in the United States on Chinese and Japanese art. In the summer of 1946 he was granted a year's leave of absence from the Museum to take the position of Chief of the Arts and Monuments Division of the Allied Forces in Japan. His duties in that position were to make recommendations to General MacArthur for the protection, salvage, preservation or disposition of certain arts and monuments. While in Japan Hollis became aware of the opportunity to acquire unusual and unique objects of art at most attractive prices. Many wealthy Japanese who possessed rare and valuable art objects and who had suffered serious economic loss from the war were willing for the first time to dispose of these art objects. This condition, together with the favorable rate of exchange, made possible the purchase of these items at comparatively low prices. Upon his return to the United States Hollis interested a limited number of his friends in the possibilities of profit inherent in this situation. Under date of August 1, 1948 a syndicate agreement was executed by Hollis and six other persons. The name of the syndicate is Hollis & Company and its stated purpose is "acquiring as an investment a limited number of oriental art objects to be purchased by Hollis on a trip which he proposed to make to Japan, such objects to be disposed of as and when their potential increment in value appears to be fully realized and inflationary economic trends warrant."

Provision was made in the syndicate agreement for a capital investment of $33,000, to be increased by an additional $16,500 if circumstances warranted. Hollis himself was without available capital, but through advancements from the other members of the syndicate (which he agreed to repay with interest) he received a fifty per cent interest therein. The agreement also provided that Hollis was to receive a ten per cent. commission on the gross selling price of all art objects, which was to be deducted before computation of the net profits, and provision was also made for a drawing account to Hollis of $500 per month. As of January [December?] 31, 1948 Hollis resigned his position with the Cleveland Museum of Art and left for Japan on January 3, 1949. He was in Japan about three months, during which time he purchased 157 art objects consisting of 194 individual pieces. Apparently, in order to purchase some of the more valuable objects, Hollis was required to and did buy some objects in the lower price range. All of these objects were shipped by air to the United States and arrived in this country about the same time that Hollis returned. Immediately after his arrival on the West Coast Hollis commenced selling the art objects. Sales were made to the Seattle Museum of Art, the Cleveland Museum of Art, the Toledo Museum of Art, and others. Some sales were made within three weeks of the purchase of the objects in Japan. The objects were kept at Hollis's home in Cleveland Heights, where they were displayed to prospective purchasers. There was no advertising and no published price lists. Hollis was well known to the connoisseurs of foreign art objects in the United States as well as to art collectors and art museums in this country. During the year 1949 Hollis had no other business and devoted most of his working time to the affairs of Hollis & Company. His only sources of income during that year were the commissions on sales and his share of the profits of the syndicate. He made three short trips and two long trips out of

Cleveland in furtherance of the sale of the art objects. The gross sales of the syndicate for the year 1949 amounted to $65,165, which yielded a substantial profit. From his share of the profits and his commissions in 1949 Hollis received about $29,000. The number of objects sold during 1949 was twenty-five, representing fourteen separate transactions. It was understood at the time of the formation of the syndicate that it was to be a "one venture proposition," and that the disposition of all the objects purchased probably could not be made for a period of several years. A distribution of profits was made by Hollis & Company in 1949 and annually thereafter. In accordance with the syndicate agreement no additional art objects were purchased. However, on April 1, 1950 a second syndicate was formed. This was known as Howard Hollis & Company. Its purpose was to deal in oriental art objects and it differed from the original syndicate in its stated purpose and in the method of distributing profits. Hollis received a sixty per cent. interest in the second partnership and it was agreed that only fifty per cent. of the net profits of Howard Hollis & Company were to be distributed annually to the syndicate members. Unlike the first syndicate, Howard Hollis & Company could thus use part of its undivided profits for the replenishment of its inventory of art objects. The second syndicate agreement was executed by Hollis and four of the original six members of the first partnership. Under the terms of the second agreement Hollis also was to receive a ten per cent. commission on sales and a drawing account of $500 per month. Hollis made trips to Japan and purchased additional art objects on behalf of Howard Hollis & Company. Meanwhile, in the year 1950, sales were made by Hollis & Company in the amount of $51,675. In the years 1951, 1952 and 1953 sales were made on behalf of both partnerships. The inventory of each partnership was segregated and displayed at the home of Hollis, and, as was true in the case of the first partnership, there was no advertising or publication of price lists of the objects owned by the second syndicate. The accounts of both partnerships were kept by a bookkeeper in the office of the law firm representing the syndicates and were designated as "Hollis No. 1" and "Hollis No. 2."

In the first year of its operation Howard Hollis & Company sold only eight more objects than did the first syndicate. In its second year Howard Hollis & Company sold eight less objects than Hollis & Company, and in the third year both partnerships sold the same number. The ratio of gross profits to gross sales of both partnerships for a period of three years shows a slightly higher average percentage of profits for Hollis & Company, but this is accounted for largely by the more favorable rate of exchange that was in effect at the time the purchases were made for the first syndicate. . . .

It is conceded by plaintiffs that Howard Hollis & Company is a dealer in oriental art objects and that the profits realized by that partnership constituted ordinary income. However, plaintiffs contend that the art objects of Hollis & Company were held for investment and that profits derived from their sale must be treated as capital gains. Plaintiffs' argument is premised in part upon the declared purpose of the syndicate members of Hollis & Company to hold the art objects as an "investment." But merely designating the purchase and sale of art objects as an "investment" is not decisive. While the stated purpose for which property is acquired is entitled to some weight, "the ultimate question is the purpose for which the property is held." Rollingwood Corp. v. C.I.R., 9 Cir., 190 F.2d 263, 266; Mauldin v. C.I.R., 10 Cir., 195 F.2d 714; Richards v. C.I.R., 81 F.2d 369, 106 A.L.R. 249.

Plaintiffs also rely upon the fact that Hollis & Company was a "one venture proposition" and contemplated no replenishment of inventory. In Ehrman v. C.I.R., 9 Cir., 120 F.2d 607, 610, the court said:

We fail to see that the reason behind a person's entering into a business — whether it is to make money or whether it is to liquidate — should be determinative of the question of whether or not the gains resulting from sales are ordinary gains or capital gains.

Cf. Richards v. C.I.R., supra.

Hollis was impressed with the opportunities for profit in selling art objects that resulted from the post-war economic condition of the Japanese people. He enlisted the financial aid of his associates and offered them a chance to participate in what promised to be a profitable venture. The members of the syndicate knew they were entering into a new and untried business venture but were willing to finance and participate in the enterprise as an experiment. Notwithstanding the stated purpose of "acquiring an investment" it was contemplated that sales efforts were to be made immediately upon the return of Hollis from Japan. After nine months of operation it was demonstrated that Hollis's optimistic view of the possibilities of profit were fully warranted. The profits realized from the sale of but a small portion of the objects purchased indicated that the long-term prospects of such a business were most favorable. Hollis then decided that it would be advantageous to engage in the business of dealing in oriental art on a permanent basis. This was the purpose of the formation of the second syndicate. Following the organization of Howard Hollis & Company and for a period of several years, art objects purchased by both syndicates were sold, and the plans, policies and procedures followed in connection therewith were the same for each partnership. It is conceded that all of the essential criteria of a business enterprise are present in the operations of Howard Hollis & Company. I am of the opinion that the same criteria appear in the operation of Hollis & Company. The syndicate of Hollis & Company provided for a drawing account of $500 per month for Hollis, effective upon his return from Japan. Hollis was to receive a commission on sales, and his selling efforts began immediately upon his return to this country. Sales were made within a short time after his return, and the sales were regular, substantial and continuous. As is clearly shown by the evidence, there is a limited number of potential buyers of oriental art objects. Because of the restricted market and the nature of the business, it was probably considered unnecessary to advertise or to publish price lists. Both in the number of transactions and in the amounts realized from sales there was little difference in the operations or results of the two partnerships. The sales of Hollis & Company were not extraordinary. As is true with the sales of Howard Hollis & Company, they were sales in the ordinary course of business.

Plaintiffs also contend that being the first to sell oriental art objects in this country, Hollis & Company had no customers. I suppose it fair to say that the first person who in 1859 bought a pound of tea from the Great Atlantic & Pacific Tea Company was just as truly a customer as the housewife who does her weekly shopping in one of the corporation's modern chain stores. Those whose custom the taxpayer seeks are its customers. Goldsmith v. C.I.R., 2 Cir., 143 F.2d 466. Hollis & Company was a "middleman" engaged in the distributon of art objects to a class different from those from whom it bought. Seeley v. Helvering, 2 Cir., 77 F.2d 323. Although the *Goldsmith* case, supra, involved the wholly dissimilar subject-matter of the sale of motion picture rights by a playwright, the concurring opinion of Judge Learned Hand in that case is instructive and relevant here. Among other things, Judge Hand said [143 F.2d at 468]:

Nevertheless, the business may consist of selling these goods in "ordinary course," to those whose custom the taxpayer seeks; and these are his "customers." That the purpose of Congress was also not to treat such transactions as "capital gains or losses" is patent. Although each transaction is the sale of "property held by the taxpayer," it is not con-

sidered as separate, but the transactions are all massed together for tax purposes as a single source of ordinary income, quite as though the taxpayer were giving his services for hire upon separate occasions. How numerous such transactions must be the statute answers only by the test that collectively they must constitute a "trade or business."

. . .

In 59 Yale Law Journal, page 838, Peter Miller of the New York Bar says:

Assuming that the federal income tax should treat like transactions alike, the special treatment accorded capital gains can be justified only if the transactions giving rise to such gains have characteristics which set them apart from transactions resulting in ordinary income.

The transactions of Hollis & Company are in all their essentials like the transactions of Howard Hollis & Company. And for the purposes of the Internal Revenue Act should be treated alike.

Judgment may be entered for defendant.

NOTE

1. *Single or liquidating venture.* Should the court have given more weight to the claim that the original syndicate was a "one venture proposition"? (Was *Mauldin* also concerned with a single venture?) When property is acquired by inheritance, the fact that the taxpayer does not intend to replace it as sales are made may help to establish that he does not hold it for sale to customers in the ordinary course of business. In Yunker v. Commissioner, 256 F.2d 130 (6th Cir. 1958), for example, a taxpayer inherited a large tract which she subdivided and sold piecemeal after trying unsuccessfully to sell it as a single parcel; emphasizing that the taxpayer had not entered upon this venture by choice and that she bought no additional property, the court held that the profit was taxable as capital gain. This "orderly liquidation" theory has not been confined to inherited property, and it has been invoked successfully by some taxpayers whose transactions were remarkably frequent and continued over many decades. See Chandler v. United States, 226 F.2d 403 (7th Cir. 1955) (liquidation commenced in 1915; property acquired in 1882-1888 by taxpayer's predecessor as compensation for constructing Texas state capital building); Alabama Mineral Land Co. v. Commissioner, 250 F.2d 870 (5th Cir. 1957) (liquidation started before 1913; property acquired by foreclosure in 1883 by taxpayer's predecessors); Western & Southern Life Insurance Co. v. United States, 163 F. Supp. 827 (Ct. Cl. 1958), and cases there cited.

If the taxpayer in the *Mauldin* case had sold all of the building lots on hand at the end of 1945 in a single transaction to one buyer, would his profit be capital gain or ordinary income? In Grace Bros., Inc. v. Commissioner, 173 F.2d 170 (9th Cir. 1949), inventory property was held to produce ordinary income when sold in bulk on discontinuance of the business; but see Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956) (contra, where property was sold by shareholders after liquidation of corporation, rather than by corporation itself); Ferber's Estate v. Commissioner, 22 T.C. 261 (1954) (on death of individual proprietor, inventory sold in bulk by executors; held, capital gain); Acro Manufacturing Co. v. Commissioner, 39 T.C. 377 (1962) (inventory property acquired by parent corporation on tax-free liquidation of subsidiary; held, capital assets).

2. *Single sale after many purchases.* The subdivision cases, and some others arising under §1221(1), typically involve piecemeal sales of a large tract or unit of property, permitting the government to argue that the taxpayer has performed the function of a middleman by buying in one market and selling in another. Note that Seltzer, supra page 475, regards this as the hallmark of "ordinary profits," as distinguished from capital gains, and that the court in *Van Suetendael* said that the taxpayer there was not a "middleman." What if the taxpayer *buys* at retail and sells at wholesale, e.g., by slowly acquiring contiguous parcels of real estate in order to sell the assembled tract in one transaction? In Thomas v. Commissioner, 254 F.2d 233 (5th Cir. 1958), involving the acquisition over a 3-year period of several mineral properties each of which was too small

for profitable exploitation, the court held that the taxpayer realized a capital gain on selling the entire tract, but without rejecting the possibility that a large number of purchases might be as damaging to the taxpayer's claim to capital gain as a large number of sales.

SECTION E. PROPERTY USED IN THE TRADE OR BUSINESS

Section 1221(2), under which real property used in the taxpayer's trade or business and depreciable personal property so used are denied the status of "capital assets," is a re-enactment of §117(a)(1)(B) of the 1939 Code.

CARTER-COLTON CIGAR CO. v. COMMISSIONER
9 T.C. 219 (1947)

Petitioner is engaged in the business of distributing tobacco products in North Carolina and South Carolina on a wholesale basis. It was incorporated in 1917, its two principal stockholders being L. J. Carter and W. E. Colton, both of whom were active in the management of petitioner's affairs. At that time, it occupied uptown leased store and warehouse quarters in Charlotte, where it kept its inventory stock of tobacco products, from which deliveries to the trade were made.

In February of 1926 petitioner purchased a vacant lot, without improvements, on West Morehead Street in Charlotte with the intention and for the purpose of having erected thereon a warehouse and store building, which was to be occupied by petitioner as its principal place of business. In the years immediately following the purchase of the lot petitioner had plans and specifications prepared for the erection of the building, but construction was not actually begun on account of the economic dislocation in connection with the depression which occurred about that time. In 1934 Carter died as the result of an accident and Colton was thereafter in responsible charge of petitioner's affairs. He decided to abandon the idea of building and to continue the business in its established location.

In 1935 the unimproved lot was offered for sale and in the years following it was placed in the hands of various real estate agencies for sale. It was finally sold in 1943.

During the years 1937 through 1943 petitioner rented billboard advertising space rights, for which it received the following rentals:

1937 and 1938	$25 per year
1939 through 1941	15 per year
1942 and 1943	10 per year

A part of the 1943 rental was refunded to the lessee because of the sale of the property before the expiration of the year.

In September of 1943 petitioner received its first and only offer to buy the property, and the sale above referred to was arranged, for $4,000. The sale resulted in a loss to petitioner in the amount of $3,068.67. Petitioner claimed a deduction for the loss in that amount as an ordinary loss. Petitioner realized no gain in 1943 from the sale of any capital asset.

OPINION

KERN, Judge: The single question for decision here is whether the loss sustained by petitioner from the sale in 1943 of the vacant lot was an ordinary or a capital loss.

It is petitioner's position that the lot was not a capital asset by reason of the 1942 amendment to [§1221(2)] of the Internal Revenue Code, which excluded from the definition of capital assets "real property used in the trade or business of the taxpayer." *

Respondent, on the other hand, contends that the real estate involved here was a capital asset, since it was never actually *used* in petitioner's trade or business, although he does not question the fact that it was bought for the purpose of being so used.

The facts are simple and undisputed; the legal question is novel, but not, we think, too difficult.

It is our view that the real property involved here was "used in the trade or business" of the petitioner, within the meaning of the statute, when it was purchased for the business purpose of causing a building to be constructed thereon to be occupied by the petitioner corporation and steps were taken looking toward the consummation of that plan, to the extent of causing plans to be drawn and specifications to be prepared for use in building on that particular lot. It seems to us that at that time some use, normal for that state of proceedings, had begun to be made of the lot for the petitioner's business purposes. Full or maximum use, of course, had not yet been made, and was finally prevented by later-developing circumstances over which petitioner had no control.

A similar question, arising under this relatively new amendment to the code, has recently been considered by this Court. Solomon Wright, Jr., 9 T.C. 173. In that case the real estate involved had ceased to be actively used in the taxpayer's business, since his business had ceased, yet we held it nevertheless not to be a capital asset.

Where the statute [§167(a)(1)] allows deductions for depreciation of property "used in the trade or business," it has been held that "used in the trade or business" means "devoted to the trade or business," and includes all such property, whether actually in use during the taxable year or not. Kittredge v. Commissioner, 88 Fed. (2d) 632; Yellow Cab Co. of Pittsburgh v. Driscoll, 24 Fed. Supp. 993; P. Dougherty Co., 5 T.C. 791, 795. The acquisition of real estate for use at its principal place of business by a corporation is a proper business purpose and function, and the real estate so purchased, in our opinion, is devoted to and "used in" the business of the corporation during the planning and building stages preparatory to actual occupancy. Its character as "real property used in . . . trade or business" continues even after the planned use becomes impossible. *Solomon Wright,* supra.

The fact that petitioner received some slight income from the property by leasing it for advertising space after petitioner had listed it for sale and pending its sale, does not seem to us to be particularly pertinent to the question before us. Such use of the property was in no way connected with petitioner's business, but was more in the nature of an incidental attempt to keep the property from being a total loss during the period when attempts were being made to dispose of it.

Upon the issue presented, we decide in favor of petitioner.

NOTE

1. *Property unsuited to business use.* The taxpayer in the *Wright* case, cited in *Carter-Colton Cigar Co.,* had held several summer cottages for rental. One of the cottages was destroyed by a hurricane; he listed the land for sale several months later and sold it at

* Before this amendment to §1221(2), only depreciable property used in the trade or business was excluded from the term "capital assets." See paragraph 3 of editor's note, infra page 552. — Ed.

a loss five years after the hurricane. The court held that the property was used in the taxpayer's trade or business.

The *Carter-Colton Cigar Co.* case was cited and followed by the Internal Revenue Service in Rev. Rul. 58-133, 1958-1 C.B. 277, involving land purchased for business use but sold at a loss after an engineering study disclosed that it was not suited to the taxpayer's needs. But see Nulex, Inc. v. Commissioner, 30 T.C. 769 (1958), holding that a fishing boat acquired by a previously dormant corporation in order to enter into the commercial charter business but not put into use because extensive alterations would be necessary before a Coast Guard license could be obtained was a capital asset.

2. *Small-scale rental activity.* In the *Carter-Colton Cigar Co.* case, the court said that the "slight income" derived from leasing the land for billboard advertising "does not seem to us to be particularly pertinent." If the rent had been more nearly commensurate with the cost or value of the property, would it have offered an alternative ground for holding that the property was used in the taxpayer's business? If the taxpayer owns an apartment house or office building, the activity incident to finding and negotiating with tenants, collecting the rents, and maintaining the building will put the taxpayer in the real estate rental business, whether he sees to the details in person or entrusts them to an agent, with the result that the property is "used in his trade or business" within the meaning of §1221(2) and does not constitute a capital asset. The leading case is Fackler v. Commissioner, 133 F.2d 509 (6th Cir. 1943):

> It is a fair inference from the evidence that petitioner acquired the [property] with the primary intention of operating the building upon it for profit and that he was not holding the property merely as an investment and solely for the purpose of collecting rents without rendering personal service to tenants. The fact may not be disputed that a person may engage in both a profession and a business [Mente v. Eisner, 266 Fed. 161 (2d Cir.)] and the fact that petitioner was engaged in the practice of law does not at all negative the fact that he was also engaged in the business of operating the building. The management of the property necessarily involved alterations and repairs commensurate with the number of tenants who occupied the building. It was also necessary to furnish elevator service, heat, light and water which required regular and continuous activity and the employment of labor, the buying of material and many other things which come within the definition of business.

The services referred to were supplied by Mr. Fackler through agents or employees; he was "a busy and successful lawyer" who "visited the . . . premises once or twice each month, which consumed one or two hours of his time."

If the property consists of a single-family dwelling, however, it is less clear that it will be treated as business property, especially if it was acquired by an individual by inheritance rather than purchased for rental purposes. Compare Grier v. United States, 120 F. Supp. 395 (D. Conn. 1954), aff'd per curiam, 218 F.2d 603 (2d Cir. 1955) (one-family house, inherited by taxpayer; held, capital asset), with Hazard v. Commissioner, 7 T.C. 372 (1946) (personal residence rented by taxpayer when he moved to another city; held, used in his trade or business). See also Union National Bank of Troy v. United States, 195 F. Supp. 382 (N.D.N.Y. 1961) (property rented on a "net" lease, requiring minimal services by owner, held a capital asset).

The proper characterization of rental property under §1221(2) is enmeshed in a bit of ancient statutory history. Before 1942, when §167(a)(2) was enacted, depreciation was allowable on property only if it qualified under §167(a)(1) — "property used in the trade or business." Similarly, until the enactment of §212 in 1942, an individual could deduct the expenses of managing property only if they qualified as business expenses under §162. Rather than deny depreciation and expenses on small parcels of rental property held by individuals, however, the government evidently allowed these deductions on the theory that all rental property is used in trade or business. Since 1942, of course, there has been less pressure on the "trade or business" concept, since depreciation is now allowed for all property held for the production of income, and an individual's expenses incurred in managing or maintaining such property are now deductible under §212.

Do the arguments for special treatment of capital gains and losses suggest how property like that in the *Fackler* case should be treated? Is there any reason why securities held by a trader like the taxpayer in the *Van Suetendael* case, supra page 535, should be a capital asset while rental property owned by an investor is not?

See Comment, The Single Rental as a "Trade or Business" Under the Internal Revenue Code, 23 U. of Chi. L. Rev. 111 (1955); Roehner, Tax Court in Error in Holding All Rental Property Is "Used in Trade or Business," 25 Taxes 1000 (1957).

3. *Section 1221(2) and non-depreciable property.* Before 1942, §1221(2) embraced only depreciable property used in the trade or business. As applied to real estate, this meant that a building used in the taxpayer's trade or business was not, although the land on which it stood was, a capital asset. To avoid the resulting difficulty of allocating a lump sum sales price between land and building, the statute was amended in 1942 to remove all real estate used in the trade or business from the capital asset category, whether it is depreciable or not. H.R. Rept. No. 2333, 77th Cong., 1st Sess., 1942-2 C.B. 372, 414. The price must still be allocated in calculating the buyer's deduction for depreciation.

Unlike real property, personal property is subject to §1221(2) only if it is depreciable; non-depreciable personalty used in the trade or business is, therefore, a capital asset. Except for antiques and works of art used for display purposes, most tangible personal property used in the trade or business is depreciable. In the case of intangible personalty, however, non-depreciable property is encountered with greater frequency. Of special importance, because of the amounts involved, are decisions holding or assuming that goodwill is a capital asset because non-depreciable (infra page 573); see also Cummins v. Commissioner, 19 T.C. 246 (1952) (seat on produce exchange is a capital asset); Huckins v. United States, 5 A.F.T.R.2d 1222 (S.D. Fla. 1960) (secret process; held, capital asset); United States v. Jones, 194 F.2d 783 (10th Cir. 1952) (bus franchise; held, capital asset).

4. *Property used in business as "quasi-capital assets."* Although §1221(2) denies capital asset status to real property and depreciable personal property used in the trade or business, property of this type ordinarily is subject to the special rules of §1231. Under this provision, described in the next section of this chapter, qualified property frequently gives rise to capital gain if it is sold at a profit, but to a deduction from ordinary income if it is sold at a loss.

SECTION F. "QUASI-CAPITAL ASSETS"

Section 1231, giving special status to gains and losses from certain types of property depending upon whether a net gain or a net loss is realized for the taxable year, is identical in principle and in most details with §117(j) of the 1939 Code.

In 1942, with the enactment of §1231, Congress added a new category of property to the pre-1942 dichotomy between capital and non-capital assets — property whose sale at a gain will usually produce a capital gain, but whose sale at a loss will ordinarily give rise to an ordinary loss. If the taxpayer sells real or depreciable personal property used in his trade or business and held for more than six months (e.g., industrial equipment, a factory, or rental real estate) and if this is his only "§1231 transaction" for the year, a gain on the sale will be treated as a capital gain, but a loss will be treated as an ordinary loss. If the taxpayer engages in more than one "§1231 transaction" during the taxable year, however, all gains and losses subject to §1231 must be aggregated; if taken together, they show a net gain, each constituent item results in capital gain or loss, but if the aggregate result is a net loss, each of the transactions gives rise to ordinary income or loss. To be more explict, the §1231 "hotchpot" embraces all recognized gains and losses during the taxable year:

(1) on the sale or exchange of real and depreciable personal property used in the trade or business and held for more than six months (excluding property

includible in inventory or held for sale to customers and most copyrights and similar property);

(2) on the sale or exchange of certain livestock, unharvested crops, timber, and coal; and

(3) on most (but not all) compulsory or involuntary conversions (resulting from destruction, theft, condemnation, etc.) of property described in (1) and (2) above or of capital assets held for more than six months.

If the hotchpot just described shows a net gain, then all gains and losses therein are treated as capital gains and losses; if it produces a net loss, the individual items are treated as ordinary income and ordinary losses.

Section 1231 is encountered most frequently on the sale of rental property (e.g., apartment houses and office buildings), business real estate, and business machinery and equipment. Because of §1231, the sale of such property at a profit usually produces capital gain, while its sale at a loss usually results in a deduction from ordinary income. This reduces the importance of cases like *Grier* and *Fackler*, supra page 551, since the taxpayer with a profit will not care whether it is a capital gain under §1221, or only by virtue of the intricacies of §1231. The cases remain important for the taxpayer who incurs a loss, however; and even for the taxpayer who has a gain, the *Grier* case assures that it will be taxed as capital gain, whereas a capital gain under §1231 depends upon the outcome of the hotchpot. It should also be noted that a taxpayer who can postpone or accelerate his §1231 transactions may be able to determine the outcome of the hotchpot in any single year and thus insure for himself a happy succession of capital gains and ordinary losses in alternate years.

In conception, §1231 was addressed to a problem of limited scope. In the early days of World War II, many shipping companies whose vessels possessed a wartime fair market value greatly in excess of adjusted basis were realizing involuntary profits upon the destruction of insured vessels by enemy action and upon the requisition of vessels for military use. Some industrial firms were also realizing involuntary profits upon the condemnation of plants and equipment by the United States for use in the war program. It seemed unfair to tax these unsolicited profits at the high rates applicable to wartime income and excess profits. To be sure, §1033 (supra p. 473) provided that the victim of an involuntary conversion need not recognize his gain; but §1033 was applicable only if the taxpayer either replaced the property, which was often impossible because of wartime priorities and shortages, or established a "replacement fund" with the proceeds of the conversion, which might have required the freezing of business capital for an unpredictable period of time. Because of these shortcomings in §1033, it seemed appropriate to provide that the gain on an involuntary conversion of business property should be taxed at the capital gains rate. At the same time, it was thought desirable to preserve the ordinary loss deduction for those taxpayers whose property had not benefited from wartime inflation, since a loss on a sale of such property merely anticipated deductions for depreciation or abandonment that would otherwise offset ordinary income. It is in order to permit gains to be reported at the favorable capital gains rate, while preserving an ordinary loss for taxpayers whose property has declined in value, that §1231 differentiates between the taxpayer with an aggregate gain and the taxpayer who, on balance, breaks even or suffers a loss.

It should not be surprising that, having decided to provide this type of relief for taxpayers whose property had been destroyed by enemy action or taken by eminent domain, the draftsmen of §1231 made it applicable to other involuntary conversions as well; the profit realized by a taxpayer whose insured property was destroyed by fire or taken by a thief was equally involuntary, §1033 was equally

unsatisfactory as a solution, and there was already statutory warrant in §1033 for treating all "involuntary conversions" the same. It is surprising, however, that §1231 as enacted was not restricted to involuntary conversions, but also included any sale or exchange of business property. Evidently the reason for such a broad reach was that some taxpayers were selling plant, machinery, and equipment, either under the implicit threat of condemnation or because of other wartime conditions (e.g., merchandise shortages), and it was thought impossible or undesirable to distinguish such sales from wholly voluntary transactions. Moreover, sales of business property to more efficient producers would stimulate war production. The upshot was a statute that went beyond its original rationale, and that has persisted long after even that has disappeared.

The hotchpot, which groups all §1231 transactions together in determining how they shall be treated, presumably reflects a theory that the impact of wartime conditions in the aggregate should be controlling, rather than the gain or loss on each item by itself. If §1231 were concerned only with wartime involuntary conversions of business property, this theory would perhaps be sound; but it is hard to explain why today the tax on the sale of an apartment house should be affected by the destruction of the taxpayer's home by fire or by his sale of a stud horse.

The inclusion in §1231 of gains or losses on the involuntary conversion of capital assets is puzzling. As to gains, some involuntary conversions (e.g., the collection of insurance proceeds upon a fire) do not constitute "sales or exchanges," infra page 581, and for such events §1231 is an indirect way of dispensing with the requirement of a sale or exchange. But why should a loss on the involuntary conversion of a capital asset be deductible from ordinary income, as §1231 will permit in cases where the hotchpot produces a net loss?

The inclusion of certain livestock, timber, and coal in §1231 represents a utilization of §1231 as a repository of tax "relief" for particular industries. In the case of timber, by virtue of §1231(b)(2) and §631, the taxpayer may elect to treat the cutting of timber as a sale, reporting as capital gain the difference between his adjusted basis and the fair market value of the uncut timber. Any additional income on the actual sale is ordinary income. In effect, the taxpayer may segregate the increment in value attendant upon natural growth (or inflation) from his lumbering profits, reporting the former as capital gain and the latter as ordinary income. An investor could achieve somewhat the same result by selling the uncut timberland, and one of the reasons for bringing the cutting of timber into §1231 was to equalize the tax treatment of two transactions (outright sale vs. cutting) having certain similarities. In vetoing the Revenue Act of 1943, President Roosevelt said in his veto message that "as a grower and seller of timber, I think that timber should be treated as a crop and therefore as income when it is sold." The bill was passed over the veto, Senator Barkley saying that President Roosevelt's timber business consisted of selling Christmas trees and that their "easy growth and short life" might justify treating them like a farmer's crop, but that "to compare these little pine bushes with a sturdy oak . . . is like comparing a cricket to a stallion." 90 Cong. Rec. 1965. In 1954, however, "these little pine bushes" found their way into §631(a) (last sentence), with no apparent complaint from the sturdy oaks. Lefevre, Tax Aspects of Timber Transactions, 18 N.Y.U. Inst. on Fed. Taxation 577 (1960); Wineberg v. Commissioner, 326 F.2d 157 (9th Cir. 1963) (§1231(b)(2) is subordinate to exclusion of inventory property, and may not be employed by dealer in timber).

In the case of coal royalties, inclusion in §1231(b)(2), via §631(c), came about in 1951. The stated reason was simply that most owners of coal properties had leased them for long terms in return for a royalty of a stated amount per ton

mined by the operator rather than for a percentage of the sales price, as in some other extractive industries. Because these fixed amounts paid by coal companies did not rise with inflation in the value of the ore, the recipients were allowed to report them as capital gain. Apart from these provisions, could a landowner who is not in the coal business report his coal royalties as capital gain? Even though the coal might be a capital asset, the "lease" would probably not constitute a "sale or exchange" because of the taxpayer's retained economic interest, namely, the right to receive a stated royalty when, as, and if coal was mined by the "lessee." Infra page 584. In 1964, §631(c) was enlarged to extend capital gain treatment to iron ore royalties to "encourage domestic leasing of iron ore properties to operators, and therefore [to] improve the position of domestic iron ore production relative to foreign production." S. Rep. No. 830, 88th Cong., 2d Sess. 120.

The inclusion in §1231 of livestock and of unharvested crops is explained infra page 560.

Section 1231 is ordinarily favorable to the taxpayer, since it holds out the possibility of capital gain treatment on assets like business real estate and depreciable equipment that would otherwise produce ordinary income.

But §1231 can also work against the taxpayer's interest. Suppose in a given taxable year the taxpayer suffers a loss of $10,000 on the sale of an apartment house and a gain of $8000 on the sale under threat of condemnation of his own residence, both items having been held for more than six months. Assume also that the taxpayer has taxable income, apart from these two transactions, of $15,000. The tax results under §1231 (the hotchpot producing a net loss), as compared with those that would obtain in the absence of §1231, are as follows:

Under §1231		*Without §1231*	
Gain on residence (ordinary income)	$ 8,000	Capital gain on residence	$ 8,000
Other taxable income	15,000	Other taxable income	15,000
	$23,000		$23,000
Loss on apartment house (ordinary)	−10,000	Loss on apartment house (ordinary)	−10,000
Taxable income	$13,000		$13,000
		Less: ½ capital gain (§1202)	−4,000
			$ 9,000

If this taxpayer's gain on his residence had been $12,000 instead of $8000, the hotchpot would produce a net gain, but the results under §1231 are still unfavorable:

Under §1231		*Without §1231*	
Net long-term capital gain	$ 2,000	Capital gain on residence	$12,000
Other taxable income	15,000	Other taxable income	15,000
	$17,000		$27,000
Less: ½ capital gain (§1202)	−1,000	Loss on apartment house (ordinary)	−10,000
Taxable income	$16,000		$17,000
		Less: ½ capital gain (§1202)	−6,000
			$11,000

By and large, however, §1231 is favorable to the taxpayer. The adverse results just noted could sometimes be avoided by postponing one transaction to another

year. Husband and wife might on occasion file separate returns, rather than a joint return, if both had §1231 transactions in the same year and two hotchpots would produce a better tax result than one.

ROLLINGWOOD CORP. v. COMMISSIONER

190 F.2d 263 (9th Cir. 1951)

Before BONE and ORR, Circuit Judges, and FEE, District Judge.

BONE, Circuit Judge.

The question to be determined by the petitions for review of a decision of the Tax Court is whether that court erred in determining that the proceeds from the sale of certain houses by the Rollingwood Corporation should be taxed as ordinary income instead of gains from the sale of capital assets. The applicable statutory provision is [§1231] . . .

The case was presented to the Tax Court on stipulated facts, a summary of which follows:

Prior to December 7, 1941 David Bohannon, one of the petitioners, was engaged in the real estate business; the business of subdividing and selling real property; and in the business of constructing homes. After the outbreak of World War II he disbanded his sales force and devoted his time and attention to war housing projects including the Rollingwood Project. Prior to the incorporation of the Rollingwood Corporation (referred to herein as Rollingwood) Bohannon was induced by the General Manager of the Richmond shipyards to sponsor a single family dwelling project in Richmond, California. Richmond and the surrounding area was a critical war effort area and suffered from a manpower shortage and inadequate housing. Bohannon was aware of the policy of the United States to provide low-cost rental housing so that war workers would not have to buy homes to stay on the job. Bohannon made two applications to the National Housing Administration and to the War Production Board for priorities and commitments to construct a total of 700 houses in Richmond. The Rollingwood Corporation was incorporated on January 9, 1943 as a California Corporation to undertake the construction and management of this project. The corporation issued fifty shares of common capital stock of a par value of $100 per share. Twenty-six of these shares were issued to Bohannon and twenty-four to Ross Chamberlain, Bohannon's partner in other ventures. On May 10, 1945 Rollingwood reacquired the twenty-four shares issued to Chamberlain.

Rollingwood acquired a tract of land in Richmond and the construction of the project was commenced in the spring of 1943. The applications for commitments and priorities made by Bohannon were assigned to Rollingwood. Certain conditions were imposed on Rollingwood by virtue of these commitments and priorities. Among them were the following: All of the houses had to be rented with an option to the tenant to purchase; the option was to extend for a period of thirty months; no initial payment could be required other than the first month's rent; the tenant could not be obligated to purchase; the houses could not be disposed of other than in accordance with the required lease without the approval of the Director of Industry Operations of the War Production Board. . . .

The 700 houses were completed by August 14, 1943 and were advertised for rent for $50.00 per month. All the houses, upon completion, were rented to war workers under rent-option agreements which agreements were in accordance with the conditions imposed by the United States. Rollingwood never employed any sales force other than general office employees to sell the houses. No "for sale" signs were ever displayed on the houses or on the Rollingwood Tract. By May

31, 1947 Rollingwood had sold 801 houses at a gross profit of $587,234.36. The total number of houses sold exceeded the number constructed because Rollingwood had re-acquired 81 by "repossession" and 24 by "repurchase." It still owned four houses on May 31, 1947. About the latter date the Rollingwood Corporation was dissolved and all its assets distributed to Bohannon. Bohannon, as transferee of the assets, is liable for whatever deficiencies are found to be due.

Coming to the merits the first contention of the petitioners is that the facts necessitate a finding that the houses were constructed primarily for rental purposes. In support of this contention they rely on the facts which show that Bohannon was aware of the "policy" of the United States to provide rental housing for war-workers; that many conditions were imposed on Rollingwood by the United States; that the houses were advertised for rent and actually rented for an average time of twenty-two months under a rental-option agreement which restricted the possibility of sale.

But these facts are not inconsistent with a purpose to sell. It is a logical inference from the above facts that Bohannon and his associate realized that to stay in the building and selling business they would have to engage in housing construction under government priorities and commitments which contained some restrictions. Nor are we convinced that they felt that the rental option agreements would tend to restrict sales. It might well be that they contemplated that these agreements would furnish a ready buyer for the individual houses.[1]

While the purpose for which the property was acquired is of some weight the ultimate question is the purpose for which the property is held. Richards v. C.I.R., 9 Cir., 81 F.2d 369. Most of the cases dealing with the problem of whether property is held primarily for sale to customers in the ordinary course of trade or business involve situations where the taxpayer is engaged in some activity apart from his usual occupation and the question is whether this activity amounts to a business. The test normally applied in these situations is the frequency and continuity of the transactions claimed to result in a trade or business. Applying that test to the facts of the instant case we have no difficulty in finding support in the record for the finding that Rollingwood is in the business of selling real property.[2]

Although the requirements of the statute are to some extent overlapping, the emphasis in this case is whether the houses were held primarily for sale or primarily for rent. Petitioners contend that the word "primarily" means "principal" or "chief," while the Commissioner contends it means "essential" or "substantial."

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[1] Many of the Tax Court decisions relied on by the petitioner and the case of Fahs v. Crawford, 5 Cir., 161 F.2d 315, are cases dealing with property originally acquired as an investment. No facts in the record in the instant case compel the assumption that the houses involved were investment property.

[2] The following table was compiled from the exhibits by the Tax Court.

Fiscal Year Ending	No. of Houses Sold (1)	(2)	(3)	(4)	Gross Profit on Sales
May 31, 1944	32	4	28	0	$ 15,946.04
May 31, 1945	224	46	175	3	144,191.74
May 31, 1946	357	221	136	0	183,421.46
May 31, 1947	188	15	165	8	243,675.12
Totals	801	286	504	11	$587,234.36

(1) The total number of houses sold exceeds 700, the number constructed because the petitioner reacquired 81 houses by repossession and 24 by repurchase. On May 31, 1947, it owned 4 of the houses.

(2) Number of houses sold under option.

(3) Number of houses sold to non-tenants.

(4) Number of houses sold to tenants who rerented without option to buy.

For reasons hereinafter stated we think the latter view is more consonant with the legislative policy.

Suppose the taxpayer in the instant case intended to rent the houses for as long as he was required to do so under existing regulations and then to sell them. Or suppose his intention was to pursue whichever of these activities proved to be the most profitable, that is, if the *rental market* were good he would continue to rent but if the *sales market* were high he would sell. In either of these suppositions we think it is fair to say that one of the essential purposes (in acquiring or holding the houses) is the purpose of sale. Under such circumstances, if the taxpayer does dispose of the houses by sale, is it within the legislative *purpose* to allow him to treat the proceeds of these sales as a capital gain? We think not.

The capital gains provisions are remedial provisions. Congress intended to alleviate the burden on a taxpayer whose property has increased in value over a long period of time from having the profits from sales taxed at graduated tax rates designed for a single year's income. The purpose is to protect "investment property" as distinguished from "stock in trade" or property bought and sold for a profit. It is our view that this policy was not meant to apply to a situation where one of the essential purposes in holding the property is *sale*. . . .

NOTE

1. *The statutory framework.* The full circle of statutory reasoning in *Rollingwood* is not explicitly stated. The houses did not constitute "capital assets" because they were disqualified by either §1221(1) (property held for sale to customers) or §1221(2) (real property used in the taxpayer's trade or business), or by both. But real property used in the trade or business, if held for more than six months, goes into the hotchpot of §1231, while property held for sale to customers, by virtue of §1231(b)(1)(B), does not. Does the court make the assumption that property used in the trade or business may *also* be held primarily for sale to customers? If so, does the statute support this assumption? Or did the court hold that the property was not used in the trade or business *because* it was held for sale to customers? If so, is depreciation pending a sale to be denied because the property does not qualify under §167(a)?

2. *Other instances.* How influential was the fact that Bohannan had engaged in the business of constructing and selling houses before 1942 and organized Rollingwood to build houses for rental only because his old method of conducting business was no longer feasible? In Victory Housing No. 2, Inc. v. Commissioner, 205 F.2d 371 (10th Cir. 1953), the court emphasized the fact that the taxpayer itself was organized to build houses for rental (under Title VI of the Federal Housing Act — the same statute that was involved in *Rollingwood*), even though there too the shareholders had previously been engaged in building houses for resale, and held that §1231 was applicable to sales of the houses once the wartime restrictions were lifted. See also Curtis Co. v. Commissioner, 232 F.2d 167 (3d Cir. 1956) (taxpayer evidently preferred to build for rental; §1231 held applicable to profit of over $3.8 million on 1100 houses sold over a 4-year period); and compare Blake v. Kavanagh, 107 F. Supp. 179 (E.D. Mich. 1952), where houses built for sale in 1926 were held to retain this character in 1942, although they had been rented in the interim.

Were there two strings to the government's bow in *Rollingwood:* that the houses were *built* with a view to sales as soon as the law permitted; and that the *process of selling* necessarily threw them into the "held for sale to customers" category? In both *Victory Housing No. 2, Inc.* and *Curtis Co.*, supra, the taxpayers successfully invoked the "orderly liquidation of capital investment" cases that are cited in the editor's note following the *Hollis* case (supra page 548); the business activity incident to selling the houses was held insufficient to convert them into property held for sale to customers.

In 1955, the Internal Revenue Service ruled that a motion picture producer who sold 200 old films, manufactured in the period 1931-1946, in a single transaction could claim the benefit of §1231; the films were used in the taxpayer's trade or business of renting

films for exhibition and were not held for sale to customers because it had never previously sold films to exhibitors. The purchaser of the films evidently was primarily interested in their use on television. Rev. Rul. 55-706, 1955-2 C.B. 300. In 1962, this ruling was superseded, on the ground that since August 1, 1948, the motion picture industry has "recognized the distinct possibility that its films might be sold for exhibition on television after being leased for theater showings and that producers generally contemplated sales to television following such showings as a likely means of exploiting their product." Assuming this to be true, does it bar recourse to §1231? Rev. Rul. 62-141, 1962-2 C.B. 182.

Do automobiles used in a car rental business (e.g., as in *Massey Motors*, supra p. 300) qualify under §1231 if the taxpayer regularly retires them from his rental fleet and sells them after a year or two of service? Does the answer depend on how much profit or loss is realized on the sales, on whether the taxpayer sells the cars at wholesale or at retail, or on whether the taxpayer is also engaged in the business of selling new cars? Note that in *Massey Motors*, supra page 302, the Supreme Court said that "the 'profits' of the taxpayers here are capital gains and incur no more than a 25% tax rate" and that "the taxpayers are able, through the deduction of this depreciation from ordinary income, to convert the inflated amounts from income taxable at ordinary rates to that taxable at the substantially lower capital gains rates." But see Greene-Haldeman v. Commissioner, 282 F.2d 884 (9th Cir. 1960) (profits on selling rental cars taxable as ordinary income); Rev. Rul. 54-229, 1954-1 C.B. 124. What is the status of an automobile dealer's gain on selling "demonstrators" or "company cars"? Latimer-Looney Chevrolet, Inc. v. Commissioner, 19 T.C. 120 (1952); Rev. Rul. 54-222, 1954-1 C.B. 19, amplified by Rev. Rul. 60-15, 1960-1 C.B. 22.

For other rental-sale transactions, see Recordak Corp. v. United States, 325 F.2d 460 (Ct. Cl. 1963) (sale of microfilming equipment on change of policy by taxpayer that had previously rented but not sold its machines; held, ordinary income); American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963) (under antitrust decree, taxpayer offered for sale equipment that it previously had rented but refused to sell; held, ordinary income); Meridian, Inc. v. Commissioner, 322 F.2d 198 (6th Cir. 1963) (construction company organized taxpayer as an affiliate to construct and lease buildings, under leases with option to purchase; held, buildings held for sale as well as for lease, and profit is ordinary income).

3. *Relation of depreciation deductions to §1231.* Although the taxpayer's profit on §1231 property is ordinarily taxed as long-term capital gain, it may constitute in whole or in part a "recapture" of depreciation that was deducted in past years from ordinary income. This disparity gives the taxpayer a powerful incentive to employ one of the accelerated depreciation methods authorized by the 1954 Code (supra p. 296), as well as to use the shortest useful life and smallest salvage value that can be expected to pass the scrutiny of the Internal Revenue Service. Sections 1245 and 1250 were enacted in 1962 and 1964 to impose statutory limitations on these practices. See Section G of this chapter.

4. *Relation of Corn Products Refining Co. doctrine to §1231.* In duPont & Co. v. United States, discussed in paragraph 1 of the editor's note following the *Corn Products Refining Co.* case, supra page 494, the government argued that profits realized on the unclaimed deposits should be taxed as ordinary income because, even if there had been a sale of the containers that met the technical standards of §1231, the income arose "from the everyday operation of the business." Admitting arguendo that "gain from the disposition of property used in the trade or business may be so closely allied to the main sources of business income that *Corn Products* may be properly applied," the court refused to apply the doctrine to the facts before it. Would *Corn Products* be relevant to a sale of houses held by a business corporation for rental to its employees, if it put them up for sale partly because the employees' union attacked the concept of company housing as "economic paternalism"? Should the answer depend on whether the taxpayer realized a gain or a loss? See Oahu Sugar Co., Ltd. v. United States, 300 F.2d 773 (Ct. Cl. 1962) (sale of houses and of building lots; held, capital gain under §1231).

Recall that in *Corn Products*, the Supreme Court said that "the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly . . . to effectuate

the basic congressional purpose." If the concept of "property used in the trade or business" is given an expansive interpretation in order to take borderline items out of the capital asset category, they ordinarily qualify for the even more favorable treatment of §1231. Does this help "to effectuate the basic congressional purpose"?

5. *Livestock held for breeding.* Animals held exclusively for breeding purposes are depreciable property used in the trade or business and even though sold when their usefulness for breeding is exhausted are not *held* primarily for sale. Hence they have always qualified under §1231. But suppose a farmer's practice is to use a substantial number of all the animals he raises for breeding purposes and to sell them after a season or two. Are such animals held primarily for sale to customers in the ordinary course of the taxpayer's business, and thus ineligible under §1231? The Treasury's attempt to deny capital gain treatment under §1231 was on the whole unsuccessful in the courts, but it litigated the issue so persistently that Congress finally intervened in 1951 to insure §1231's applicability. See §1231(b)(3). The leading case under §1231 prior to its amendment is Albright v. United States, 173 F.2d 339 (8th Cir. 1949); and see Halstead, Capital Gains of Farmers, 25 So. Calif. L. Rev. 36, 57-64 (1951).

Under §1231(b)(3), the livestock owner is assured of capital gains treatment if the animals are held for draft, breeding, or dairy purposes even though they are also held for sale. The application of §1231 to such animals is a shining example of bartering deductions from ordinary income for capital gains. The cost of raising the animals is usually deducted from ordinary income; but if the §1231 hotchpot shows a net gain, the profit on sale is long-term capital gain. To illustrate by an extreme example, assume that the cost of raising an animal is $100, deducted from income that would otherwise be taxed at the rate of 50 per cent, and that the animal is sold for $100. Has the owner made a profit? What if he sells the animal for $80?

6. *Unharvested crops.* If a farmer sells a farm with an unharvested crop at a profit, and this is his only transaction under §1231 for the taxable year, is the entire profit taxable as a capital gain under §1231, or is the profit allocable to the crop taxable as ordinary income on the theory that the crop, even though unharvested and unripe, is held primarily for sale to customers? In Watson v. Commissioner, 345 U.S. 544 (1953), the Supreme Court held that the profit on the crop must be taxed as ordinary income. Under a line of lower court cases to the contrary, the taxpayer might have had a taxable loss despite his enjoyment of an economic gain. Assume that the land cost $10,000, that the expenses of raising the crop were $2000, that the "package" is sold for $13,000, and that the sales price is allocable $10,000 to the land and $3000 to the crop. Under the decisions rejected by the *Watson* case, the farmer would have $3000 of capital gain, of which 50 per cent could be deducted under §1202, and $2000 of expenses deductible under §162(a). The Revenue Act of 1951 added §1231(b)(4), §268, and §1016(a)(11) to the Code; they have the effect of allowing capital gain on the sale, but at the expense of capitalizing the costs of raising the crop. How would the example just given be affected by these sections? See Halstead, Capital Gains of Farmers, cited supra paragraph 5.

7. *Uncompensated casualty losses under §1231.* Note that §1231(a) speaks of "gains from the compulsory or involuntary conversion . . . of property used in the trade or business and capital assets held for more than 6 months *into other property or money*" (emphasis supplied) and of "losses from such . . . conversions." Does this imply that a loss resulting from an involuntary conversion (e.g., destruction by fire, or theft) is subject to §1231 only if the taxpayer receives some "other property or money" from his insurance company or the thief? The Regulations state that such losses are within the scope of §1231 even though the taxpayer receives no compensation, Regs. §1.1231-1(e), but Maurer v. United States, 284 F.2d 122 (10th Cir. 1960), holds that uncompensated casualty losses are deductible under §165, and need not go into the §1231 hotchpot. (If the taxpayer has no other §1231 transactions during the taxable year, the result would be the same whether he relies on §165 or on §1231; but if there are other §1231 transactions, the *Maurer* case insures that the uncompensated casualty loss will be deductible from ordinary income regardless of the outcome of the §1231 hotchpot.)

The last sentence of §1231(a), enacted in 1958, takes uncompensated casualty losses out of the hotchpot if the property is used in the trade or business or is a capital asset held for the production of income. The taxpayers in *Maurer* could not rely on this provision,

however, because their dispute involved the taxable year 1954, and the property (their residence) was not held for the production of income. In recommending enactment of the 1958 provision, the Senate Finance Committee expressed the view that it represented a change in the law and removed "an unintended hardship." S. Rept. No. 1983, 85th Cong., 2d Sess., reprinted in 1958-3 C.B. 922, 995. The Internal Revenue Service has announced its non-acquiescence in *Maurer*. Rev. Rul. 61-54, 1961-1 C.B. 398.

SECTION G. CAPITAL GAINS AND THE DEPRECIATION DEDUCTION

Section 1245, providing for the "recapture" (as ordinary income) of post-1961 depreciation deductions when certain classes of property are sold at a gain, was enacted in 1962.

Section 1250, providing for the "recapture" of some post-1963 depreciation deductions taken with respect to real estate, was enacted in 1964.

Section 1239, requiring the gain on a sale of depreciable property between spouses or between an individual and a corporation controlled by him or certain members of his family to be reported as ordinary income, is identical with §117(o) of the 1939 Code.

Before enactment of the Revenue Act of 1962, and to a lesser degree even thereafter, §1231 encouraged the taxpayer to depreciate business property as rapidly as possible, since depreciation deductions reduce ordinary income, while any profit realized on an ultimate sale of the property goes into the §1231 hotchpot and is ordinarily taxable as long-term capital gain. This disparity was accentuated by the enactment in 1954 of §167(b), sanctioning the use of accelerated methods of depreciating property. The Internal Revenue Service, for its part, has adopted some countermeasures to restrict this opportunity to obtain current deductions from ordinary income in return for reporting long-term capital gains in the future. Closer administrative attention to estimated salvage values tends to prevent the "over-depreciation" of property; indeed, if the salvage value used in computing the amount to be depreciated turns out to correspond precisely with the amount realized on an ultimate sale of the property, the taxpayer's depreciation deductions will be equal to the cost of using the property during its business life and there will be no gain at the time of the sale. Although salvage values need not be re-estimated from year to year in the light of current market values, the courts have given powerful support to the Service's campaign by holding that the salvage value of property that is customarily retired before its physical exhaustion (e.g., automobiles used in a car rental business) must be based on the property's resale or second-hand value, not on its value to a junk dealer. Massey Motors, Inc. v. United States, supra page 300; see also Hertz Corp. v. United States, supra page 305 (applying same rule to property depreciated by declining balance method). Moreover, the Internal Revenue Service has ruled that no depreciation may be taken in the year an asset is sold if the sales price equals or exceeds its adjusted basis at the beginning of the year. Rev. Rul. 62-92, 1962-1 C.B. 29; Cohn v. United States, 259 F.2d 371 (6th Cir. 1958); but see Motorlease Corp. v. United States, 215 F. Supp. 356 (D. Conn. 1963) (ruling not applicable if estimates of useful life and salvage value were reasonable when made).

A more radical remedy for the ordinary-income, capital-gain syndrome, however, was prescribed by §1245 of the Revenue Act of 1962: when the taxpayer disposes of certain depreciable property, his gain (if any) must be reported as ordinary income to the extent of his post-1961 depreciation deductions. This "recapture" of depreciation applies only to "§1245 property" — depreciable per-

sonal property (except livestock) and depreciable tangible real property (other than buildings and their structural components) if devoted to certain uses (manufacturing, extraction, transportation, communications, gas and electric services, etc.). (The term "§1245 property" is substantially identical with the term "§38 property," used in computing the investment credit of §38, but it does not contain a useful life restriction.) Depreciation is "recaptured" by §1245(a) not merely when property is sold, but also when it is distributed as a corporate dividend, transferred in a corporate liquidation, or disposed of in certain other ways; if there is no "amount realized" because the property is not sold, exchanged, or involuntarily converted, the property's fair market value at the time of the disposition is employed in determining whether the taxpayer has realized a gain.

Although §1245 thus reaches many transactions that do not fall into the §1231 hotchpot, the existence of §1231 was undoubtedly the principal reason for its enactment, and §1231 transactions will probably furnish the principal occasions for its application. It should be noted, however, that §1245 does not totally eliminate the possibility of reporting a profit on the sale of depreciable property as long-term capital gain under §1231: buildings and their structural components, as well as some other categories of property, are not subject to §1245; pre-1962 depreciation deductions are not taken into account by §1245; and gain is unaffected by §1245 to the extent that it exceeds post-1961 depreciation. To illustrate the latter two limitations on §1245, assume that the taxpayer purchased a ship for $500,000 on January 1, 1961, deducted $40,000 as depreciation annually during the years 1961, 1962, and 1963 and sold the ship (because of a war scare) for $600,000 on December 31, 1963. His gain is $220,000 (i.e., $600,000 less adjusted basis of $380,000); his "recomputed basis" under §1245(a)(2) is $460,000 (adjusted basis of $380,000 plus post-1961 depreciation of $80,000), and $80,000 of his gain (excess of recomputed basis over adjusted basis) is taxable as ordinary income under §1245(a). The balance of his gain ($140,000) is untouched by §1245 and goes into the §1231 hotchpot. Note that if the taxpayer enjoys a gain on §1245 property, it is taxable as ordinary income to the extent of his post-1961 depreciation, whether the gain results from depreciating the property faster than the "normal" decline in its market value or from unanticipated inflation. Thus, if the ship had a market value on December 31, 1962, equal to its then adjusted basis ($420,000), the taxpayer would have realized no gain on selling it on that date; a sale for $600,000 on December 31, 1963, however, produces $80,000 of ordinary income under §1245 even though the entire gain is attributable to inflation induced by a war scare.

The enactment of §1245 should serve to reduce friction between taxpayers and revenue agents over the useful lives and salvage values employed in depreciating §1245 property, since excessive depreciation will be recaptured on most transfers of such property. But can §1245 be reconciled with legislative efforts to encourage new investment by sanctioning rapid depreciation methods in 1954 and enacting the investment credit in 1962? Note that the ordinary income implications of §1245, as well as the fact that it creates taxable income on some transfers that were not previously taxable occasions (e.g., certain corporate liquidations), may lead some taxpayers to abandon the use of rapid depreciation methods for §1245 property. This possibility was explicitly acknowledged by the enactment of §167(e) (allowing taxpayers to shift from declining balance and sum-of-the-year-digits methods to straight-line depreciation) as a companion to §1245.

The willingness of the Internal Revenue Service to promulgate the 1962 depreciation guidelines (supra p. 298), with their shorter lives for machinery and other business equipment, is partly explained by the enactment of §1245: taxpayers

using the guideline lives for property that is later sold at a profit will have to "give back" the excess depreciation as ordinary income under §1245.

By the enactment of §1250 in 1964, the recapture mechanism was extended to buildings and other real property not subject to §1245, but the reach of §1250 is more modest than that of §1245. Under §1250, depreciation is fully recaptured only if the property was held for 12 months or less; thereafter, only the excess (if any) of the depreciation taken over straight-line depreciation is subject to recapture, and even this excess is subject to §1250 only on a sliding scale under which the percentage taken into account is reduced if the property is held for more than 20 months by one percentage point for each month thereafter. Thus, 100 per cent of the excess is subject to recapture if the property is held for 20 months, 99 per cent if it is held for 21 months, etc., so that §1250 ceases to operate if the property is held for more than 120 months.

By virtue of §47, the investment credit of §38 is recaptured in whole or in part if there is an early disposition of property that qualified for the credit (i.e., if the property is disposed of before it has been used for the period of time used in computing the credit).

Section 1238, requiring the profit on a sale of "emergency facilities" (supra p. 298) to be reported as ordinary income rather than capital gain to the extent that the rapid amortization deducted by the taxpayer exceeded normal depreciation, may be regarded as a prototype — albeit in a very limited area — of §1245.

Section 1239 is still another statutory provision that was enacted by Congress (in 1951) because of §1231's favorable treatment of gain realized on depreciable property used in the trade or business. It provides that gain on a sale or exchange of depreciable property between spouses or between an individual and a corporation controlled (as defined) by him or certain members of his family is to be reported as ordinary income. Previously a stepped-up basis for depreciable property could be obtained by selling it to a controlled corporation; the gain would go into the §1231 hotchpot and would usually come out as long-term capital gain (possibly to be reported on the installment basis over a period of years), while the transferee would acquire a new basis for computing depreciation. See Sun Properties v. United States, 220 F.2d 171 (5th Cir. 1955). Section 1239 does not apply to all intra-family transactions, however, and although §1245 now supplies a second string to the government's bow, it seems likely that most transactions of this type involve buildings rather than §1245 property. Moreover, the owner of an apartment house or similar rental property whose property is fully depreciated or who has a low depreciable basis for property that has risen substantially in market value can sell his property to an outsider and invest the proceeds in comparable property, thus getting a stepped-up basis at the capital gain rate basis without running afoul of §1239. Indeed, several taxpayers who have "run out of depreciation" may find it possible to sell their assets to each other, taking care to avoid §1031 (non-recognition of gain on exchanges of investment property), and thus start with clean slates in computing depreciation on their newly acquired properties. These possibilities were, of course, made less attractive by the enactment of §1250 in 1964.

Section 707(b)(2) is a counterpart, in the partnership area, of §1239.

See generally Schapiro, Recapture of Depreciation and Section 1245 of the Internal Revenue Code, 72 Yale L.J. 1483 (1963).

Section H. Patents, Copyrights, and the Like

1. *Before 1950*

Until 1950, the Code did not explicitly prescribe the tax treatment of patents, inventions, copyrights, manuscripts, and similar property. Capital gains and losses would be realized only if, under the general provisions of the statute, the patent, copyright, or other item was a "capital asset" and was "sold or exchanged."

To meet the first requirement — that the property be a capital asset — the taxpayer had to show that it was neither held for sale to customers in the regular course of trade or business nor depreciable property used in his trade or business. In general, capital gains were thus confined to "amateur" inventors and authors, though this category might embrace a person who was employed to invent or write if what he sold was the result of spare-time work outside the scope of his employment. See Myers v. Commissioner, 6 T.C. 258, 266 (1946); Pike v. United States, 101 F. Supp. 100 (D. Conn. 1951). Patents and copyrights might also have qualified as "quasi-capital" assets under what is now §1231, if used in the trade or business and not held for sale to customers, though this was not entirely clear. See Avery v. Commissioner, 47 B.T.A. 538 (1942); Diescher v. Commissioner, 35 B.T.A. 732, 743; General Spring Corp. v. Commissioner, ¶53,257 P-H Memo T.C.; cf. Rev. Rul. 55-706, 1955-2 C.B. 300 (§1231 applicable to unusual sale of motion picture films held for rental), superseded by Rev. Rul. 62-141, 1962-2 C.B. 182.

Meeting the second requirement — that the capital asset be "sold" or "exchanged" — was easy if the patent or invention was sold for a specified sum. But the typical method of exploiting inventions and literary works is to allow commercial enterprises to use them in return for royalties, and the Internal Revenue Service took the position that a patent or copyright that was licensed for use on a royalty basis was not "sold" or "exchanged" within the meaning of what is now §1222. This argument was rejected in a number of cases; see, for example, Dreymann v. Commissioner, 11 T.C. 153, 162-163, where the court said:

> We do not agree with respondent's contention that to apply the benefits of the long term capital gains provisions . . . would be repugnant to the "underlying theory of the capital gains limitations." He argues that the purpose of the capital gains limitations is to lessen the impact of the Federal income tax "on the realization in one lump sum in one taxable year of an increment in value which had taken place over a number of years." Since petitioner here did not sell the process for one lump sum, he concludes, the application of the capital gains limitations in the case at bar would defeat the intent and purpose of Congress. In the first place, the applicable statute does not contain any provision to the effect that payment from the sale of a capital asset must be in one lump sum. Respondent supports his position, however, by pointing to House Report No. 350, 67th Cong., 1st sess. (C.B. 1939-1 (Part 2), p. 176). That report accompanied the Revenue Act of 1921, which first introduced the capital gains provision into our taxing statute. It reads in part as follows:
>
> > Section 206: The sale of farms, mineral properties, and other capital assets is now seriously retarded by the fact that gains and profits earned over a series of years are under the present law taxed as a lump sum (and the amount of surtax greatly enhanced thereby) in the year in which the profit is realized. . . .
>
> There is nothing in the House report or in the Senate report which supports respondent's assertion that a taxpayer, in order to have the tax benefit of the capital gains provisions, must sell his asset for one lump sum. As a matter of fact, this and other courts

have held that where, as here, the consideration for the sale of a capital asset was in the form of periodic payments based on a percentage of the gross sales made during the year, the taxpayer was entitled to a capital gains limitation on the sums received in each year. See Commissioner v. Celanese Corporation, 140 F.2d 339; George James Nicholson, 3 T.C. 596, and cases cited therein. We can find no valid reason for holding otherwise in this case.

See also Myers v. Commissioner, 6 T.C. 258 (1946), holding that an exclusive license of a patent is a sale, as required for capital gain treatment. Despite its failure to persuade the courts, the Internal Revenue Service persisted in its view — no doubt much influenced by the anomaly of capital gains being realized for the product of personal service and skill — until 1958. In that year, the Service finally acquiesced in the *Myers* case as to patent royalties, and in 1960 it announced that it would apply the same principle to copyrights. Rev. Rul. 58-353, 1958-2 C.B. 408; Rev. Rul. 60-226, 1960-1 C.B. 26.

Another problem in this area was whether the transfer of rights in a copyright or patent was a "sale" if the transferee was restricted to a particular medium (e.g., motion pictures, magazine publication, etc.) or to a prescribed geographical area. The Internal Revenue Service for some time insisted that such transfers were "licenses" rather than "sales," relying mainly on precedents from the law of patents and copyrights which drew these distinctions, e.g., in determining the proper party to sue for infringement. After losing Herwig v. United States, 105 F. Supp. 384 (Ct. Cl. 1952), holding that Kathleen Winsor's transfer of the motion picture rights to "Forever Amber" was a "sale" rather than a "license," however, the Internal Revenue Service issued Rev. Rul. 54-409, 1954-2 C.B. 174, acknowledging that a copyright can be divided into separate properties, provided an exclusive right to exploit it in a particular medium is granted. But see Cory v. Commissioner, 230 F.2d 941 (2d Cir. 1956) (transfer of part of the bundle of rights in a manuscript is not a sale when the consideration is wholly indeterminate at the time of transfer).

The transfer of an exclusive right to exploit a patent in a limited geographical area has also been held to be a "sale." Marco v. Commissioner, 25 T.C. 544 (1955) (exclusive rights under an American patent in the United States west of the Mississippi River); Cleveland Graphite Bronze Co. v. Commissioner, 10 T.C. 974, 988 (1948), aff'd per curiam, 177 F.2d 200 (6th Cir. 1949) (rights under British patent limited to England); Reid v. Commissioner, 26 T.C. 622 (1956) (rights limited to United States). In Dairy Queen, Inc. v. Commissioner, 250 F.2d 503 (10th Cir. 1957), the transfer of the exclusive use of a patented machine in a restricted area, under an agreement by the transferee to maintain quality and other standards, was held to be a "sale" rather than a "license." There is a conflict on whether a transfer of the right to exploit a patent in a particular industry is a "sale" or "license." Compare United States v. Carruthers, 219 F.2d 21 (9th Cir. 1955) (finding no reason for distinguishing between a geographic and an industry limitation), with American Chemical Paint Co. v. Smith, 131 F. Supp. 734 (E.D. Penn. 1955) (distinguishing *Carruthers* on the ground that the patents involved there had established value in only one industry).

Up to this point, as stated above, there was no distinction between the inventor and the author. From 1950 on, however, their paths diverged.

2. *The 1950 Amendments: Authors, Composers, and Artists*

Section 1221(3), providing that a copyright, literary composition, or similar property, held by its creator or by a person whose basis is determined by reference to the creator's basis, is not a "capital asset," is identical with §117(a)(1)(C) of the 1939 Code.

Section 1231(b)(1)(C), providing that such assets do not qualify for "quasi-capital asset" treatment under §1231, is identical with §117(j)(1)(C) of the 1939 Code.

In 1948 the financial arrangements for the publication of General Eisenhower's "Crusade in Europe" were extensively discussed in the press. The New Yorker reported:

> The manuscript was finished on March 24th and sold to Doubleday early this month [October, 1948] for a sum that has been rumored to be somewhere between a hundred thousand and a million dollars. There hadn't been any doubt that Doubleday would buy the book. The reason for the hiatus, and for an outright sale rather than the usual royalties deal, was a ruling by the income-tax people that in this way Eisenhower would qualify for a twenty-five-per-cent capital-gains tax on the transaction, instead of being subject to the graduated income tax. The capital-gains tax is limited to twenty-five per cent only in the case of so-called capital assets held at least six months, and apparently writers can get in under it when they are non-professionals. If the General should write a second book, he might find himself in the same tax boat as Norman Mailer and Dale Carnegie. We note that he has recently taken up painting, on an amateur basis.

During the 1952 Presidential campaign General Eisenhower made public the Treasury's ruling, which was followed a year later by a closing agreement, to the effect that capital gain would be realized on the assumption that

> you propose to sell to a publisher in one transaction all of your right, title and interest in your literary work, and that after such sale, you would have no further control over the manuscript or its exploitation in any field or medium of publication . . . that there would be no further income of any kind accruing to you after the single transaction. [New York Times, Oct. 15, 1952, p. 22.]

The emphasis on the sale of all rights for a lump sum reflects the Internal Revenue Service's pre-1958 view that a royalty arrangement would defeat the concept of a "sale," as well as its pre-1954 theory that a division of publication rights among several transferees was a "license," not a "sale." Supra page 565.

About the same time that General Eisenhower's transaction occurred, it was reported that the Columbia Broadcasting Company had lured Amos 'n Andy, Jack Benny, and other performers away from the National Broadcasting Company by a series of "capital gains deals." The details were not publicly announced at the time, but it was reported that the performers sold the "shows" — embracing scripts, trade names, goodwill, rights to the characters and manner of rendition, etc. — for flat sums, simultaneously entering into long-term employment contracts. Every Broadway and Hollywood columnist had his own explanation of the tax advantages thereby gained; speculation was reported on whether Faust's sale of his soul to the Devil gave rise to ordinary income or capital gain.

The bubble was pricked on January 3, 1949, when the Internal Revenue Service issued this laconic statement:

> The tax effect of any business transaction is determined by its realities.
>
> Accordingly, proposals of radio artists and others to obtain compensation for personal services under the guise of sales of property cannot be regarded as coming within the

capital gains provisions of the Internal Revenue Code. Such compensation is taxable at ordinary income tax rates.

While this announcement evidently discouraged further transactions of this type, it did not prevent Jack Benny from litigating a deficiency assessed against him based on his sale of the stock of a corporation that was under contract to produce several radio shows (including Benny's). To refute the government's claim that 90 per cent of the sales price (about $2.2 million) was in reality compensation for his personal services, Benny established that his agents negotiated with CBS for the sale of the stock and arrived at a price before discussing his services, and that they threatened to break off negotiations entirely if CBS tried to discuss both subjects simultaneously. CBS, the court concluded, agreed to buy the stock without any assurance that Benny would switch from NBC to CBS. With three judges dissenting, the court held that the form of the transaction corresponded with its substance, and that Benny's profit was capital gain. Benny v. Commissioner, 25 T.C. 197 (1955). On somewhat similar facts, Groucho Marx also enjoyed a capital gain; his method of separating the consideration for the literary properties from the compensation to be paid for his personal services was to require CBS and NBC to submit separate offers in the form of sealed bids. Marx v. Commissioner, 29 T.C. 88 (1957). For discussion, see Rosenbaum, Entertainer's Corporations and Capital Gains, 12 Tax L. Rev. 33 (1956).

In 1950, Congress enacted what is now §1221(3) to exclude copyrights, literary, musical and artistic compositions, and similar property from the term "capital assets" when held either by the creator or by a person whose basis for the property is determined by reference to the creator's basis (e.g., a donee or a controlled corporation). At the same time, to prevent such assets from producing capital gain indirectly, §1231(b)(1)(C) was enacted to keep them out of the hotchpot of §1231.

The House of Representatives proposed to treat inventors like authors, but the Senate Finance Committee demurred:

> Your committee believes that the desirability of fostering the work of such [occasional] inventors outweighs the small amount of additional revenue which might be obtained under the House bill, and therefore the words "invention," "patent," and "design" have been eliminated . . . [S. Rept. No. 2375, 81st Cong. 2d Sess., reprinted in 1950-2 C.B. 483, 515.]

It should be noted that the 1950 legislation may have failed to touch the radio performers whose antics evoked the amendments; Jack Benny sold the stock of a corporation, not literary or musical properties, and Groucho Marx sold his interest in a partnership. Does §1221 (3) disqualify the stock of a corporation if its assets include, or consist wholly of, literary properties?

When do copyrights, literary and musical compositions, and similar property constitute capital assets despite §1221 (3)? See Fidler v. Commissioner, 231 F.2d 138 (9th Cir. 1956) (literary property purchased as an investment with the hope of a profitable resale; held, under pre-1950 law, capital assets).

The Internal Revenue Service has ruled that motion picture films produced by a publicly held corporation did not come within the scope of §1221(3):

> No participating interests in the films sold were held by any individuals as joint venturers in a particular production. The films sold were produced by the efforts of individuals who were paid . . . the then full market value of their efforts and services. None of such individuals owned stock in the corporation at the time the films were made, or owned any stock or stock options in the corporation at the time of the sale of the films. None of the individuals contributed efforts and services to the production of these films with a view toward subsequently realizing additional money returns, directly or indirectly,

through the medium of the sale of the films upon a capital gain basis. [Rev. Rul. 55-706, 1955-2 C.B. 300, superseded (on other grounds) by Rev. Rul. 62-141, 1962-2 C.B. 182.]

On the meaning of "literary composition" and "similar property" as used in §1221(3), see Stern v. United States, 164 F. Supp. 847 (E.D. La. 1958), aff'd per curiam, 262 F.2d 957 (5th Cir. 1959) (motion picture rights to "Francis," the talking mule; held, a "literary composition" even if not subject to copyright). In Regenstein v. Commissioner, 35 T.C. 183 (1960), the court suggested that a plan for group insurance for government employees, devised by an agent who specialized in group insurance plans, constituted "similar property" within the meaning of §1221(3) (assuming that it constituted "property" at all), but the case was decided on the ground that a disputed payment received by the taxpayer was for personal services rather than for the plan or idea.

It should be noted that §§1301-1307 (relating to income averaging, infra page 827) may provide some tax relief for authors and inventors whose income is "bunched" and does not qualify for the capital gain rate. Another method of avoiding the telescoping of income is to make an "installment sale" of the copyright or other property. Under §453(b) the income realized on the sale is taxed as the installments are received. Ex-President Truman, who decided to sell his memoirs after the enactment of §1221(3), was granted a ruling in late 1953 approving a proposed installment sale under §453(b). Infra page 813.

3. *The 1954 Amendment: Inventors*

Section 1235, providing that royalties and other income received by inventors and certain other persons on the transfer of "all substantial rights" to a patent or interest therein qualify as long-term capital gains, was enacted in 1954, but was subsequently made retroactive to 1950 by §117(q) of the 1939 Code.

In 1954, just four years after Congress amended §1221 so that the transfer of a copyright or similar property would generate ordinary income even for the *amateur* author, it enacted §1235 to insure that income from certain transfers of patents will be taxed as long-term capital gain even if received by a *professional* inventor. The purpose of the legislation was "to provide an incentive to inventors to contribute to the welfare of the Nation." S. Rept. on 1954 Code, 439. The professional inventor thus joins the stock "trader" in the select group of taxpayers who can report their regular income — not just occasional supplements to it — as long-term capital gains. For the background of §1235, see United States v. Zacks, 375 U.S. 59 (1963).

Section 1235 applies only to a "holder" of a patent (or of an undivided interest therein), a term that refers to an individual "whose efforts created such property" or who acquired his interest from the creator for a consideration in money or money's worth before the invention covered by the patent was reduced to practice. Neither the creator's employer nor a person related to the creator within the degrees specified in §267(b) and §1235 (d), however, can qualify as a "holder." If a holder transfers "property consisting of all substantial rights to a patent, or an undivided interest therein which includes a part of all such rights," the transfer is to be treated as the sale or exchange of a capital asset held for more than six months. Moreover, §1235 applies even if the payments received by the holder are contingent on the transferee's use of the patent and payable over the period of use. To prevent a holder from exploiting a patent through a related corporation or family partnership and employing §1235 to draw off manufacturing

profits in the form of long-term capital gains, however, the patent may not be transferred to a related person, as defined by §267(b) and §1235(d).

The Regulations provide that the requirement of a transfer of "all substantial rights" is not satisfied by a license limited geographically, functionally, or in time. Regs. §1.1235-2(b); and see Young v. Commissioner, 29 T.C. 850 (1958) (agreement terminable by holder on six months' notice not a transfer of "all substantial rights"); First National Tr. & Savings Bank v. United States, 200 F. Supp. 274 (S.D. Cal. 1961) (retention of right to terminate for nonpayment of royalties not inconsistent with §1235 transfer, but transfer of all rights *remaining* after an earlier non-exclusive license does not qualify); Ruge v. Commissioner, 26 T.C. 138 (1956) (transferor was entitled to use patented apparatus in his own work; transaction treated as a transfer of all substantial rights, with license back to transferor of minor rights).

For problems in determining whether an employee has been paid for services or for a patent, see Chilton v. Commissioner, 40 T.C. 552 (1963), and cases there cited.

If an inventor deducts depreciation after 1961 with respect to a patent and then disposes of it in a way that meets the standards of §1235, must part of his profit be reported as ordinary income under §1245?

The Regulations provide that a transfer of a patent that falls outside §1235 (e.g., transfers by a "holder" to a "related person" or by a person who is not a "holder") will be governed by the other provisions of the Code. Regs. §1.1235-1-(b). See also, to the same effect, Coplan v. Commissioner, 28 T.C. 1189 (1957) (patent transferred to a related corporation in a bona fide, arm's-length transaction); Holcomb v. Commissioner, 30 T.C. 354 (1958) (sale by wife, who had received an interest in a patent as a gift from inventor-husband). Note the importance in this connection of the cases (in which the government finally acquiesced) holding that the "sale or exchange" requirement of §1222 is satisfied even though the transferor of a patent receives royalties contingent on the transferee's use. Myers v. Commissioner, and Rev. Rul. 58-353, supra page 565.

What is the basis upon which gain or loss on the sale of a patent by its inventor is to be computed? See Regs. §1.167(a)-6(a). With respect to "developmental or experimental expenses, etc.," which the regulation treats as the cost of a patent, recall that the Service's policy has been to allow the "expensing" of these costs where the taxpayer has done so consistently. Supra page 316. After deducting such costs, could the taxpayer include them in the patent's basis on the theory that the Service should not have allowed the deductions? An amateur inventor would probably not be allowed to deduct his costs even under the Service's lenient policy.

See generally Note, A Comparison of the Tax Treatment of Authors and Inventors, 70 Harv. L. Rev. 1419 (1957); Pilpel, Tax Law Affecting Copyrights: 1954-1956, 35 Taxes 76 (1957); Kragen and Barton, The Tax Dilemma of the Entertainer, 31 So. Calif. L. Rev. 390 (1958); Dunn, Tax Considerations in Patent Assignments and Licenses Between Related Corporations, 16 Tax L. Rev. 315 (1961); Duke, Foreign Authors, Inventors, and the Income Tax, 72 Yale L.J. 1093 (1963).

SECTION I. SALE OF A GOING BUSINESS

WILLIAMS v. McGOWAN

152 F.2d 570 (1945)

Before L. HAND, SWAN, and FRANK, Circuit Judges.

L. HAND, Circuit Judge.

This is an appeal from a judgment dismissing the complaint in an action by a taxpayer to recover income taxes paid for the year 1940. . . .

Williams, the taxpayer, and one, Reynolds, had for many years been engaged in the hardware business in the City of Corning, New York. On the 20th of January, 1926, they formed a partnership, of which Williams was entitled to two-thirds of the profits, and Reynolds, one-third. They agreed that on February 1, 1925, the capital invested in the business had been $118,082.05, of which Reynolds had a credit of $29,029.03, and Williams, the balance — $89,053.02. At the end of every business year, on February 1st, Reynolds was to pay to Williams, interest upon the amount of the difference between his share of the capital and one-third of the total as shown by the inventory; and upon withdrawal of one party the other was to have the privilege of buying the other's interest as it appeared on the books. The business was carried on through the firm's fiscal year, ending January 31, 1940, in accordance with this agreement, and thereafter until Reynolds' death on July 18th of that year. Williams settled with Reynolds' executrix on September 6th in an agreement by which he promised to pay her $12,187.90, and to assume all liabilities of the business; and he did pay her $2,187.98 in cash at once, and $10,000 on the 10th of the following October. On September 17th of the same year, Williams sold the business as a whole to the Corning Building Company for $63,926.28 — its agreed value as of February 1, 1940 — "plus an amount to be computed by multiplying the gross sales of the business from the first day of February, 1940 to the 28th day of September, 1940," by an agreed fraction. This value was made up of cash of about $8100, receivables of about $7000, fixtures of about $800, and a merchandise inventory of about $49,000, less some $1000 for bills payable. To this was added about $6000 credited to Williams for profits under the language just quoted, making a total of nearly $70,000. Upon this sale Williams suffered a loss upon his original two-thirds of the business, but he made a small gain upon the one-third which he had bought from Reynolds' executrix; and in his income tax return he entered both as items of "ordinary income," and not as transactions in "capital assets." This the Commissioner disallowed and recomputed the tax accordingly; Williams paid the deficiency and sued to recover it in this action. The only question is whether the business was "capital assets" under [§1221].

It has been held that a partner's interest in a going firm is for tax purposes to be regarded as a "capital asset." Stilgenbaur v. United States, 9 Cir., 115 F.2d 283; Commissioner v. Shapiro, 6 Cir., 125 F.2d 532, 144 A.L.R. 349. We too accepted the doctrine in McClellan v. Commissioner, 2 Cir., 117 F.2d 988, although we had held the opposite in Helvering v. Smith, 2 Cir., 90 F.2d 590, 591, where the partnership articles had provided that a retiring partner should receive as his share only his percentage of the sums "actually collected" and "of all earnings . . . for services performed." Such a payment, we thought, was income; and we expressly repudiated the notion that the Uniform Partnership Act had, generally speaking, changed the firm into a juristic entity. See also Doyle v. Commissioner,

4 Cir. 102 F.2d 86. If a partner's interest in a going firm is "capital assets" * perhaps a dead partner's interest is the same. New York Partnership Law §§61,62(4), Consol. Laws N.Y. c. 39. We need not say. When Williams bought out Reynolds' interest, he became the sole owner of the business, the firm had ended upon any theory, and the situation for tax purposes was no other than if Reynolds had never been a partner at all, except that to the extent of one-third of the "amount realized" on Williams' sale to the Corning Company, his "basis" was different. The judge thought that, because upon that sale both parties fixed the price at the liquidation value of the business while Reynolds was alive, "plus" its estimated earnings thereafter, it was as though Williams had sold his interest in the firm during its existence. But the method by which the parties agreed upon the price was irrelevant to the computation of Williams' income. The Treasury, if that served its interest, need not heed any fiction which the parties found it convenient to adopt; nor need Williams do the same in his dealings with the Treasury. We have to decide only whether upon the sale of a going business it is to be comminuted into its fragments, and these are to be separately matched against the definition in [§1221], or whether the whole business is to be treated as if it were a single piece of property.

Our law has been sparing in the creation of juristic entities; it has never, for example, taken over the Roman "universitas facti";[1] and indeed for many years it fumbled uncertainly with the concept of a corporation. One might have supposed that partnership would have been an especially promising field in which to raise up an entity, particularly since merchants have always kept their accounts upon that basis. Yet there too our law resisted at the price of great and continuing confusion; and, even when it might be thought that a statute admitted, if it did not demand, recognition of the firm as an entity, the old concepts prevailed. Francis v. McNeal, 228 U.S. 695. And so, even though we might agree that under the influence of the Uniform Partnership Act a partner's interest in the firm should be treated as indivisible, and for that reason a "capital asset" within [§1221], we should be chary about extending further so exotic a jural concept. Be that as it may, in this instance the section itself furnishes the answer. It starts in the broadest way by declaring that all "property" is "capital assets," and then makes three exceptions. The first is "stock in trade . . . or other property of a kind which would properly be included in the inventory"; next comes "property held . . . primarily for sale to customers"; and finally, property "used in the trade or business of a character which is subject to . . . allowance for depreciation." In the face of this language, although it may be true that a "stock in trade," taken by itself, should be treated as a "universitas facti," by no possibility can a whole business be so treated; and the same is true as to any property within the other exceptions. Congress plainly did mean to comminute the elements of a business; plainly it did not regard the whole as "capital assets."

As has already appeared, Williams transferred to the Corning Company "cash," "receivables," "fixtures" and a "merchandise inventory." "Fixtures" are not capital because they are subject to a depreciation allowance; the inventory, as we have just seen, is expressly excluded. So far as appears, no allowance was made for "good-will"; but, even if there had been, we held in Haberle Crystal Springs Brewing Company v. Clarke, Collector, 2 Cir., 30 F.2d 219, that "good-will" was a depreciable intangible. It is true that the Supreme Court reversed

* Although a partner's interest in a partnership is a capital asset, part of the consideration received on a sale of the interest may be taxable as ordinary income by virtue of statutory changes enacted in 1954, infra pages 760-761. — Ed.

[1] "By universitas facti is meant a number of things of the same kind which are regarded as a whole; e.g. a herd, a stock of wares." Mackeldey, Roman Law §162.

that judgment — 280 U.S. 284 — but it based its decision only upon the fact that there could be no allowance for the depreciation of "good-will" in a brewery, a business condemned by the Eighteenth Amendment. There can of course be no gain or loss in the transfer of cash; and, although Williams does appear to have made a gain of $1072.71 upon the "receivables," the point has not been argued that they are not subject to a depreciation allowance. That we leave open for decision by the district court,* if the parties cannot agree. The gain or loss upon every other item should be computed as an item in ordinary income.

Judgment reversed.

FRANK, Circuit Judge (dissenting in part).

I agree that it is irrelevant that the business was once owned by a partnership. For when the sale to the Corning Company occurred, the partnership was dead, had become merely a memory, a ghost. To say that the sale was of the partnership's assets would, then, be to indulge in animism.

But I do not agree that we should ignore what the parties to the sale, Williams and the Corning Company, actually did. They did not arrange for a transfer to the buyer, as if in separate bundles, of the several ingredients of the business. They contracted for the sale of the entire business as a going concern. Here is what they said in their agreement: "The party of the first part agrees to sell and the party of the second part agrees to buy, *all of the right, title and interest* of the said party of the first part *in and to the hardware business* now being conducted by the said party of the first part, *including* cash on hand and on deposit in the First National Bank & Trust Company of Corning in the A. F. Williams' Hardware Store account, in accounts receivable, bills receivable, notes receivable, merchandise and fixtures, including two G.M. trucks, good will and all other assets of every kind and description used in and about said business. . . . Said party of the first part agrees not to engage in the hardware business within a radius of twenty-five miles from the City of Corning, New York, for a period of ten years from the 1st day of October 1940."

To carve up this transaction into distinct sales — of cash, receivables, fixtures, trucks, merchandise, and good will — is to do violence to the realities. I do not think Congress intended any such artificial result. In the Senate Committee Report on the 1942 amendment to [§1221(2), supra p. 552], it was said: "It is believed that this Senate amendment will be of material benefit to businesses which, due to depressed conditions, have been compelled to dispose of their plant or equipment at a loss. The bill defines property used in a trade or business as property used in the trade or business of a character which is subject to the allowance for depreciation, and real property held for more than six months which is not properly includible in the inventory of the taxpayer if on hand at the close of the taxable year or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. If a newspaper purchased the plant and equipment of a rival newspaper and later sold such plant and equipment at a loss, such plant and equipment, being subject to depreciation, would constitute property used in the trade or business within the meaning of this section." These remarks show that what Congress contemplated was not the sale of a going business but of its dismembered parts. Where a business is sold as a unit, the whole is greater than its parts. Businessmen so recognize; so, too, I think, did Congress. Interpretation of our complicated tax statutes is seldom aided by saying that taxation is an eminently practical matter (or the like). But this is one instance where, it seems to me, the practical aspects of the matter should guide our guess as to what Congress meant. I believe Congress had those aspects in

* The decision on remand is reported at 70 F. Supp. 31 (W.D.N.Y. 1947). — ED.

mind and was not thinking of the nice distinctions between Roman and Anglo-American legal theories about legal entities.

NOTE

1. *Fragmentation of going business.* Although there is a suggestion in Hatch's Estate v. Commissioner, 198 F.2d 26 (9th Cir. 1952), of disagreement with Judge Hand's approach, Williams v. McGowan was cited with approval by the Supreme Court in Watson v. Commissioner, 345 U.S. 544 (1953). The same process of fragmentation would be required on the sale of a going business by a corporation.

In the case of a partnership, however, it is necessary to determine whether the partners sold their partnership interests or the firm sold the business. See Kaiser v. Glenn, 216 F.2d 551 (6th Cir. 1954). On a sale of a partnership interest, the 1954 Code requires a degree of fragmentation (primarily to insure that the seller's share of the firm's "unrealized receivables" and "substantially appreciated inventory" will be reported as ordinary income, infra p. 761), but the fragmentation is more complete on a sale by the firm of the going business.

2. *Accounts receivable.* Section 1221(4) was enacted in 1954 to provide that accounts receivable acquired on the sale of inventory property will be non-capital assets, thus rejecting the contrary rule of Graham Mill & Elevator Co. v. Thomas, 152 F.2d 564 (5th Cir. 1945) (accounts receivable held for collection, not for sale to customers in the ordinary course of business; hence, capital assets); see also City Stores Co. v. United States, 225 F. Supp. 867 (E.D. Pa. 1964) (refusing to apply *Corn Products* doctrine). Could the same result have been reached by applying the *Corn Products Refining Co.* rationale? By referring only to accounts receivable arising "from the sale of [inventory] property," does §1221(4) imply that accounts arising out of the rental of property (e.g., by an automobile rental agency) are capital assets? What is the status of accounts arising out of a sale of property described in §1221(2) (property used in the trade or business) or §1221(3) (copyrights held by creator)?

Note that taxpayers on the accrual basis will have reported their accounts receivable as income when the property was sold, so that the gain or loss to which §1221(4) applies may be minimal. For cash basis taxpayers, however, §1221(4) is more significant.

3. *Goodwill.* On the sale of a successful business, the purchase price ordinarily exceeds the aggregate market value of the plant, equipment, fixtures, inventory, accounts receivable, and similar assets. This additional value, known as goodwill, resides in such intangibles as the organization, trained staff, business reputation, established clientele, trade names, location and operational methods of the enterprise. Certain other assets, such as secret processes, lists of customers and other business records, long-term contracts, leases, licenses, and franchises, are sometimes also treated as part of goodwill, even though it may be possible to split them off from the going business for separate sale. Did the taxpayers in *Eidson* and *Nelson Weaver Realty*, supra page 518-519, sell goodwill?

The Internal Revenue Service has acknowledged that goodwill is a capital asset, presumably in reliance on a statement in the Regulations denying that goodwill is depreciable. Rev. Rul. 57-480, 1957-2 C.B. 47; Regs. §1.167(a)-3. If the contrary view (espoused by Judge L. Hand in Williams v. McGowan) were accepted, it would be a non-capital asset, and gain or loss on goodwill held for more than six months would go into the §1231 hotchpot.

If a business is sold for a lump sum, the amount attributable to goodwill is sometimes reached by assigning a market value to the plant, equipment, fixtures, inventory, etc., and attributing the residue of the sales price to goodwill. Since goodwill is often defined as the "excess earning power" of the business, resulting from the fact that its profits exceed the profits that would normally be expected of the plant, equipment, inventory, business capital, and other separate assets, should the price received for goodwill be treated as a substitute for ordinary income under the *Hort* and *Lake* rationale? Note that in determining how a recovery in an antitrust case is to be reported, the cases distinguish between a recovery for loss of goodwill and a recovery of "lost profits" (*Raytheon Production Corp.* case, supra p. 86).

As is seen infra, the Internal Revenue Service has sought to limit the concept of good-

will, and hence the possibility of realizing capital gain, when the business that is sold consists of a profesional practice or other personal service enterprise.

4. *Covenants not to compete.* Payments received under a covenant not to compete, unrelated to the sale of a going business or of goodwill, have long been taxed as ordinary income rather than capital gain. Why? See Salvage v. Commissioner, 76 F.2d 112 (2d Cir. 1935). Even if the covenant accompanies a sale of a going business with its goodwill, the parties will ordinarily be taken at their word if they negotiate for the covenant and assign part of the sales price to it. Rogers v. United States, 290 F.2d 501 (9th Cir. 1961); see also Wilson Athletic Goods Manufacturing Co., Inc. v. Commissioner, 222 F.2d 355 (7th Cir. 1955) (purchaser allowed to amortize cost of covenant not to compete, despite lack of an allocation in the agreement). But in Michaels v. Commissioner, 12 T.C. 17 (1949), the taxpayer was accorded capital gain on a lump sum received for the goodwill of a business that he conducted as an individual proprietorship and for his personal covenant not to compete, the court saying:

> If such an agreement [not to compete] can be segregated, not so much for purposes of valuation as in order to be assured that a separate item has actually been dealt with, the agreement is ordinary income and not the sale of a capital asset. . . . But where it accompanies the transfer of good will in the sale of a going business and it is apparent that the covenant not to compete has the function primarily of assuring to the purchaser the beneficial enjoyment of the good will which he has acquired, the covenant is regarded as nonseverable and as being in effect a contributing element to the assets transferred . . .
>
> We have accordingly found as a fact, though the matter is not free from doubt, that the agreement to refrain from competition should be treated as a capital asset ancillary to the transfer of good will and customers. [12 T.C. at 20.]

The sale of the stock of a corporation is also often accompanied by an agreement not to compete. Hamlin v. Commissioner, 209 F.2d 761 (10th Cir. 1954), involved a sale of stock with a covenant by the stockholders not to compete for a period of ten years. After a draft contract was prepared under which the seller was to pay $1,000,000 for the stock with no stated amount for the covenant, the buyer suggested a change by which $750,000 would be allocated to the stock and $250,000 to the covenant:

> He stated in substance that the purpose of the suggested provision was to make such provision for non-competition enforceable and to help him and his associates taxwise. With very little discussion, the stockholders present agreed to the suggested provision, because they thought it would make no difference to them. [209 F.2d at 763.]

The court held that the covenant was not ancillary to a sale of goodwill (as in the *Michaels* case, supra) because the sellers sold stock and not a going business; and it also held that the sellers were bound by the allocation in the contract despite the circumstances under which they agreed to it. Consequently the amount received for the covenant was ordinary income, and the amount received for the stock gave rise to capital gain or loss. In Gazette Telegraph Co. v. Commissioner, 19 T.C. 692, 696 (1953), the same allocation was accepted in computing the buyer's amortization of the covenant. There it was stated that the buyers

> insisted upon a fixed and separate consideration for the covenant not to compete in order to establish its value and also for the purpose of fixing liquidated damages to be paid in the event of its breach.

See also Paul, The Lawyer As a Tax Adviser, infra page 974, for an interesting anecdote regarding an ethical problem in this area.

5. *Allocation of price among various assets of going business.* To the extent that the buyer and seller of a going business have some honest leeway in determining how the price to be paid should be allocated among the inventory, land, buildings, machinery and vehicles, goodwill, covenants not to compete, and other assets, will their interests coincide or conflict? (Consider, as a new factor in this area, the impact of §1245 and §1250.) See Ullman v. Commissioner, 264 F.2d 305 (2d Cir. 1959) (parties' own allocation

as to covenants not to compete is prima facie binding on them, since their "tax avoidance desires . . . are ordinarily antithetical, forcing them, in most cases, to agree upon a treatment which reflects the parties' true intent with reference to the covenants [not to compete], and the true value of them in money"); Levine v. Commissioner, 324 F.2d 298 (3d Cir. 1963) (allocation between goodwill and covenant not to compete).

6. *References.* Joseph, Considerations in Applying the Rule of Williams v. McGowan, 13 Tax L. Rev. 369 (1958); Barnet, Covenants Not to Compete: Their Effects upon the Covenantor and Covenantee, 18 N.Y.U. Inst. on Fed. Taxation 861 (1960).

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Advice has been requested as to the treatment, for Federal income tax purposes, of payments received from the sale of a business or profession, under the various situations described below, where the success of such business depends solely upon the professional skill, ability, integrity and other personal characteristics of the owner.

Transferable goodwill does not attach to the business of a professional man or firm, or to any other business, the success of which depends solely upon the professional skill, ability, integrity and any other personal characteristics of the owner. Neither does a following based on personal friendship or acquaintanceship constitute transferable goodwill. See Providence Mill Supply Company v. Commissioner, 2 B.T.A. 791 and MacDonald v. Commissioner, 3 T.C. 720, acquiescence, C.B. 1944-18. However, in Wyler v. Commissioner, 14 T.C. 1251, the court recognized that goodwill may be sold by professional men. Vendible goodwill may attach to a particular firm name, if the right to the exclusive use of such name may be assigned to and exercised by the assignee. Thus, if a sale of such a business or profession includes the right to the exclusive use of the firm name of the business or profession, the portion of the sales price attributable to the assignment of such right shall be treated as derived from the sale of goodwill. Since goodwill is a capital asset, any gain resulting from its sale constitutes capital gain. Revenue Ruling 55-79, C.B. 1955-1, 370.

However, each case must be decided upon the basis of its own facts to determine the extent to which the consideration received is from the sale of goodwill. For example, if the seller retains a right to fees collected after the sale for services performed before the sale, or receives payment for relinquishment of all or part of his right to such fees, the amount received by him under this arrangement is attributable to services performed before the sale rather than to the sale of goodwill and would thus constitute ordinary income. Also, if the seller retains a right to any fees or revenue collected for services performed at any time after the sale, or the purchaser agrees to pay an amount equal to any part of such fees or revenue, the nature of his interest in the business or profession and the earnings therefrom is such that the amounts received by him under this arrangement constitute ordinary income from the business rather than proceeds from the sale of goodwill. Further, where a member of a professional firm transfers to another person a part of his interest in the firm and purports to assign a right to use the firm name, no part of the consideration received by him for the transfer will be regarded as being received upon a sale of goodwill if his name is in the firm name and he continues to be a member of the firm.

Even in a case where a professional firm sells its entire business for a sum certain, only a proper part of the sales price may be allocated to the goodwill transferred by reason of an assignment of the right to use the firm name. If assets other than such right are sold, a reasonable part of the sales price shall be

allocated to such assets. Revenue Ruling, 55-79, supra. If the assignment of the exclusive right to use the firm name is accompanied by a covenant by the assignor not to compete under another name, no part of the sales price to such covenant shall be regarded as derived from the sale of goodwill.

In view of the above, where the business of a professional man or firm, or any other business, which is dependent solely upon the professional skill or other characteristics of the owner, is sold without a valid assignment of the right to the exclusive use of the firm name, no portion of the sales price may be treated as the proceeds from the sale of goodwill.

REV. RUL. 60-301

1960-2 C.B. 15

The Internal Revenue Service has been requested to state whether the decision of the Court of Appeals for the Fifth Circuit in the case of Estate of F. G. Masquelette et al., v. Commissioner, 239 Fed. (2d) 322, affects the position expressed in Revenue Ruling 57-480, C.B. 1957-2, 47.

Revenue Ruling 57-480 states, in part, that vendible goodwill may attach to a particular firm name, if the right to the exclusive use of such name may be assigned to and exercised by the assignee. It concludes that where the business of a professional man or firm, or any other business, which is dependent solely upon the professional skill or other characteristics of the owner, is sold without a valid assignment of the right to the exclusive use of the firm name, no portion of the sales price may be treated as the proceeds from the sale of goodwill.

In the *Masquelette* case, an accounting firm sold the "practice" of its El Paso office to the four local partners. The contract of sale stated that a certain amount was paid for the tangible assets of the firm and an additional amount was paid for such intangibles as the right to serve clients within a restricted area, vendors' interests in clients' files, library, office quarters, etc., and an agreement by the sellers not to compete, but excluding the right to use the firm name. The Court of Appeals, in reversing the Tax Court of the United States, concluded that the stipulations, written contract and undisputed evidence required a decision that the taxpayers sold their goodwill and that this was partially effectuated by their agreement not to compete. The fact that the contract of sale specifically provided that the purchasers should not use the name "Masquelette" in connection with their accounting practice was not regarded as controlling.

The Service will follow the decision in the *Masquelette* case only to the extent that it stands for the proposition that the existence of transferable goodwill may be recognized in connection with the sale of a business or profession, the success of which is *not* dependent solely upon the personal qualifications of the owner, even though such a sale does not involve the assignment of the right to the exclusive use of the firm name.

It is, therefore, the position of the Service that personal characteristics or qualifications do not constitute goodwill as an item of property and do not exist in such form that they can be the subject of transfer. Consequently, if a business is dependent *solely* upon the personal characteristics and competence of the owner, no element of goodwill exists with respect thereto and no portion of the sale price of the business may be treated as proceeds from the sale of goodwill, irrespective of whether or not such sale comprehends a valid assignment of the right to the exclusive use of the firm name.

However, the existence of transferable goodwill may be recognized in connection with the sale of a business, the success of which is *not* dependent solely upon

the personal characteristics of the owner, even though such sale does not comprehend a valid assignment of the exclusive use of the firm name. As indicated in Revenue Ruling 57-480, the question whether goodwill is involved in the sale of a business is essentially one of fact to be determined in each case in the light of all the surrounding circumstances.

It follows from the above that Revenue Ruling 57-480 was *not* intended to approve the concept that the professional skill, ability, integrity and other personal characteristics of the owner may qualify as that item of property called goodwill.

Accordingly, Revenue Ruling 57-480 is hereby clarified to reflect the view that where a business which is dependent *solely* upon the professional skill or other personal characteristics of the owner is sold, no portion of the sales price may be treated as proceeds from the sale of goodwill even though such sale involves a valid assignment of the right to the exclusive use of the firm name. That ruling is further clarified to reflect the view that the existence of transferable goodwill may be recognized in connection with the sale of a business, the success of which is not dependent solely upon the personal characteristics of the owner, even though such sale does not comprehend a valid assignment of the exclusive use of the firm name.

NOTE

1. *Other cases of professional goodwill.* The Internal Revenue Service seems to be fighting a losing battle in this area: see also Watson v. Commissioner, 35 T.C. 203 (1960) (capital gain on sale of accounting practice to two men with whom vendor formed a partnership); Brooks v. Commissioner, 36 T.C. 1128 (1961) (accord, sale of branch office of orthodontic practice); Rees v. United States, 187 F. Supp. 924 (D. Ore. 1960), aff'd per curiam, 295 F.2d 817 (9th Cir. 1961) (sale of part interest in orthodontic practice, seller becoming a partner of buyers; held, capital gain). The Service announced in Rev. Rul. 62-114, 1962-2 C.B. 15, that it would not follow the *Rees* case.

2. *Reference.* McDonald, Goodwill and the Federal Income Tax, 45 Va. L. Rev. 645 (1959).

Section J. Requirement of "Sale or Exchange"

HELVERING v. HAMMEL

311 U.S. 504 (1941)

Mr. Justice Stone delivered the opinion of the Court.

We are asked to say whether a loss sustained by an individual taxpayer upon the foreclosure sale of his interest in real estate, acquired for profit, is a loss which, under [§165(c)(2)], may be deducted in full from gross income for the purpose of arriving at taxable income, or is a capital loss deductible only to the limited extent provided in [§§165(f) and 1211 (b)]. . . .

Respondent taxpayers, with other members of a syndicate, purchased "on land contract" a plot of land in Oakland County, Michigan, for the sum of $96,000, upon a down payment of $20,000. The precise nature of the contract does not appear beyond the fact that payments for the land were to be made in installments, and the vendor retained an interest in the land as security for payment of the balance of the purchase price. Before the purchase price was paid in full the syndicate defaulted on its payments. The vendor instituted foreclosure proceedings by suit in equity in a state court which resulted in a judicial sale of the

property, the vendor becoming the purchaser, and in a deficiency judgment against the members of the syndicate. Respondents' contribution to the purchase money, some $4,000, was lost. . . .

It is not denied that it was the foreclosure sale of respondents' interest in the land purchased by the syndicate for profit, which finally liquidated the capital investment made by its members and fixed the precise amount of the loss which respondents seek to deduct as such from gross income. But they argue that the "losses from sales" which by [§165(f)] are made deductible only to the limited extent provided by [§1211(b)] are those losses resulting from sales voluntarily made by the taxpayer, and that losses resulting from forced sales like the present not being subject to the limitations of [§1211(b)] are deductible in full like other losses under [§165(c)(2)].

To read this qualification into the statute respondents rely on judicial decisions applying the familiar rule that a restrictive covenant against sale or assignment refers to the voluntary action of the covenantor and not to transfers by operation of law or judicial sales in invitum. See Guaranty Trust Co. v. Green Cove & M.R. Co., 139 U.S. 137; Gazlay v. Williams, 210 U.S. 41; Riggs v. Pursell, 66 N.Y. 193. But here we are not concerned with a restrictive covenant of the taxpayer, but with a sale as an effective means of establishing a deductible loss for the purpose of computing his income tax. The term sale may have many meanings, depending on the context, see Webster's New International Dictionary. The meaning here depends on the purpose with which it is used in the statute and the legislative history of that use. Hence the respondents argue that the purpose of providing in the 1934 Act for a special treatment of gains or losses from capital assets was to prevent tax avoidance by depriving the taxpayer of the option allowed to him by the earlier acts, to effect losses deductible in full by sales of property at any time within two years after it was acquired, which until held for that period was not defined as a capital asset.*

It is said that since losses from foreclosure sales not within the control of the taxpayer are not within the evil aimed at by the 1934 Act, they must be deemed to be excluded from the reach of its language. To support this contention respondents rely on the report of the Ways and Means Committee submitting to the House the bill which, with amendments not now material, became the Revenue Act of 1934. The Committee in pointing out a "defect" of the existing law said: "Taxpayers take their losses within the two year period and get full benefit therefrom and delay taking gains until the two-year period has expired, thereby reducing their taxes." H. Rept. 704, 73d Cong., 2d Sess., pp. 9 and 10.

But the treatment of gains and losses from sales of capital assets on a different basis from ordinary gains and losses was not introduced into the revenue laws by the 1934 Act. That had been a feature of every revenue law beginning with the Act of 1921, 42 Stat. 227, and each had defined as capital losses "losses from sales or exchanges of capital assets." The 1934 Act made no change in this respect but for the first time it provided that "capital assets" should include all property acquired by the taxpayer for profit regardless of the length of time held by him and that capital gains and losses from sales of capital assets should be recognized in the computation of taxable income according to the length of time the capital assets are held by the taxpayer, varying from 100% if the capital asset is held for not more than a year to 30% if it is held more than ten years. [§117(a), 1934 Act.] Finally, for the first time, the statute provided that capital losses in excess of capital gains should be deducted from ordinary income only to

* Under the Revenue Act of 1928, the holding period was part of the definition of "capital assets," which included only property held for more than two years. — Ed.

the extent of $2,000. Thus by treating all property acquired by the taxpayer for profit as capital assets and limiting the deduction of capital losses in the manner indicated, the Act materially curtailed the advantages which the taxpayer had previously been able to gain by choosing the time of selling his property.

The definition of capital losses as losses from "sales" of capital assets, as we have pointed out, was not new. As will presently appear, the legislative history of this definition shows that it was not chosen to exclude from the capital assets provisions losses resulting from forced sales of taxpayers' property. And, if so construed, substantial loss of revenue would result under the 1934 Act, whose purpose was to avoid loss of revenue by the application of the capital assets provisions. In drafting the 1934 Act the Committee had before it proposals for stabilizing the revenue by the adoption of the British system under which neither capital gains nor losses enter into the computation of the tax. In declining to follow this system in its entirety the Committee said: "It is deemed wiser to attempt a step in this direction without letting capital gains go entirely untaxed." It accordingly reduced the tax burden on capital gains progressively with the increase of the period up to ten years, during which the taxpayer holds the capital asset, and permitted the deduction, on the same scale, of capital losses, but only to the extent that there are taxable capital gains, plus $2,000. In thus relieving capital gains from the tax imposed on other types of income, it cannot be assumed, in the absence of some clear indication to the contrary, that Congress intended to permit deductions in full of losses resulting from forced sales of the taxpayers' property, from either capital gains or ordinary gross income, while taxing only a fraction of the gains resulting from the sales of such property. See White v. United States, 305 U.S. 281, 292; Helvering v. Inter-Mountain Life Ins. Co., 294 U.S. 686, 689, 690.

The taxation of capital gains after deduction of capital losses on a more favorable basis than other income, was provided for by §206 of the 1921 Revenue Act, as the means of encouraging profit-taking sales of capital investments, H. Rept. No. 350, 67th Cong., 2d Sess., p. 8. Burnet v. Harmel, 287 U.S. 103, 106. In this section, as in later Acts, capital net gain was defined as "the excess of the total capital gain over the sum of capital deductions and capital losses"; capital losses being defined as the loss resulting from the sale or exchange of capital assets. In submitting the proposed Revenue Act of 1924, the House committee pointed out that the 1921 Act contained no provision for limiting deduction of capital losses where they exceeded the amount of capital gains. H. Rept. No. 179, 68th Cong., 1st Sess., p. 14. This was remedied by providing in §208(c) that the amount by which the tax is reduced on account of a capital loss shall not exceed 12½% of the capital loss. In commenting on this provision the Committee said, p. 20: "If the amount by which the tax is to be increased on account of capital gains is limited to 12½% of the capital gain it follows logically that the amount by which the tax is reduced on account of capital losses shall be limited to the 12½% of the loss." This provision was continued without changes now material until the 1934 Act. §208(c) in the 1924 and 1926 Acts; §101 (b) in the 1928 and 1932 Acts, 47 Stat. 191.

Congress thus has given clear indication of a purpose to offset capital gains by losses from the sale of like property and upon the same percentage basis as that on which the gains are taxed. See United States v. Pleasants, 305 U.S. 357, 360. This purpose to treat gains and deductible losses on a parity but with a further specific provision provided by §117(d) of the 1934 Act, permitting specified percentages of capital losses to be deducted from ordinary income to the extent of $2,000, would be defeated in a most substantial way if only a percentage of the gains were taxed but losses on sales of like property could be deducted in

full from gross income. This treatment of losses from sales of capital assets in the 1924 and later Acts and the reason given for adopting it afford convincing evidence that the "sales" referred to in the statute include forced sales such as have sufficed, under long accepted income tax practice, to establish a deductible loss in the case of non-capital assets. Such sales can equally be taken to establish the loss in the case of capital assets without infringing the declared policy of the statute to treat capital gains and losses on a parity.

We can find no basis in the language of the Act, its purpose or its legislative history, for saying that losses from sales of capital assets under the 1934 Act, more than its predecessors, were to be treated any differently whether they resulted from forced sales or voluntary sales. True, courts in the interpretation of a statute have some scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results, United States v. Katz, 271 U.S. 354, 362, or would thwart the obvious purpose of the statute, Haggar Co. v. Helvering, 308 U.S. 389. But courts are not free to reject that meaning where no such consequences follow and where, as here, it appears to be consonant with the purposes of the Act as declared by Congress and plainly disclosed by its structure.

It is not without significance that Congress, in the 1934 Act, enlarged the scope of its provisions relating to losses from sales of capital assets by including within them losses upon the disposition of the taxpayer's property by methods other than sale and without reference to the voluntary action of the taxpayer. It thus treats as losses from sales or exchanges the loss sustained from redemption of stock, retirement of bonds, losses from short sales, and loss sustained by failure of the holder of an option to exercise it [§§331(a)(2), 1232, 1233, and 1234], although none of these transactions involves a loss from a sale.

The scope of the capital loss provisions was still further enlarged by §23(k)(2) of the Revenue Act of 1938 [§165 (g), 1954 Code], which provides that if securities, which are capital assets, are ascertained to be worthless and are charged off within the taxable year the loss, with an exception not now material, shall be considered as a loss arising from a sale or exchange. These provisions disclose a consistent legislative policy to enlarge the class of deductible losses made subject to the capital assets provisions without regard to the voluntary action of the taxpayer in producing them. We could hardly suppose that Congress would not have made provision for the like treatment of losses resulting from a forced sale of the taxpayer's property acquired for profit either in the 1934 or 1938 Act, if it had thought that the term "sales or exchanges" as used in both acts did not include such sales of the taxpayer's propery.

Respondents also advance the argument, sustained in Commissioner v. Freihofer, 102 F.2d 787, that the definitive event fixing respondents' loss was not the foreclosure sale but the decree of foreclosure which ordered the sale and preceded it. But since the foreclosure contemplated by the decree was foreclosure by sale and the foreclosed property had value which was conclusively established by the sale for the purposes of the foreclosure proceeding, the sale was the definitive event establishing the loss within the meaning and for the purpose of the revenue laws. They are designed for application to the practical affairs of men. The sale, which finally cuts off the interest of the mortgagor and is the means for determining the amount of the deficiency judgment against him, is a means adopted by the statute for determining the amount of his capital gain or loss from the sale of the mortgaged property.

The court below also thought that the loss suffered by respondents could not be treated as a loss from a sale since by the law of Michigan the vendor upon a land-contract containing the usual forfeiture clause had the right to deprive

respondents and their joint adventurers of all interest in the property by a declaration of forfeiture, and that the only additional advantage of foreclosure was to obtain a deficiency judgment. But there is nothing in this record to show that the land contract in this case contained a forfeiture clause. Even if it did, it does not appear that there was in fact a forfeiture apart from the sale on foreclosure. Cf. Davidson v. Commissioner, 305 U.S. 44, 46; Helvering v. Midland Insurance Co., 300 U.S. 216, 224; United States v. Phellis, 257 U.S. 156, 172.

Reversed.

MR. JUSTICE ROBERTS is of opinion that the judgment should be affirmed for the reasons stated in the opinion of the Circuit Court of Appeals, 108 F.2d 753.

NOTE

1. *Relation of "sale or exchange" to requirement of a "closed transaction."* Does the Court imply that every "closed transaction" involving a capital asset is a "sale or exchange" of the asset? If so, it soon repudiated the implication by holding in Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 249 (1941), that the taxpayer had not engaged in a "sale or exchange" when its plant was destroyed by fire and it recovered compensation for the loss from its insurance company:

> Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words "sale" and "exchange" are not to be read any differently. Compare Helvering v. Hammel. . . . Neither term is appropriate to characterize the demolition of property and subsequent compensation for its loss by an insurance company. Plainly that pair of events was not a sale. Nor can they be regarded as an exchange, for "exchange" . . . implies reciprocal transfers of capital assets, not a single transfer to compensate for the destruction of the transferee's asset.

If the taxpayer has engaged in a closed transaction with a capital asset, so that gain or loss is to be recognized, is there any reason to apply the capital gain and loss provisions only if the transaction constitutes a "sale or exchange"? It has sometimes been suggested that the term "sale or exchange" was deliberately chosen by Congress to encompass a more limited range of transactions than the term "sale or other disposition" in §1001(a) (providing that gain or loss "from the sale or other disposition of property" is the difference between its adjusted basis and the amount realized), but one might infer, to the contrary, that the difference in language was accidental from the fact that the recognition provision — §1001(c) — also uses the phrase "sale or exchange" yet is usually said to embrace *all* closed transactions. As will be seen, at a number of points the Code explicitly provides that transactions shall be treated as sales or exchanges even though they clearly or arguably would not otherwise qualify, and in the *William Flaccus Oak Leather Co.* case, supra, the Court implied that Congress has thereby provided an exclusive list of the "ambiguous transactions" that are to be treated as sales or exchanges.

The possibility should be kept in mind that in deciding that a particular transaction with a capital asset is not a "sale or exchange," the courts may be focusing on the basic question of whether the transaction is "closed," rather than on the narrower issue of whether the taxpayer's gain or loss is capital or ordinary. In such a case, the capital gain and loss provisions are inapplicable not because there was no "sale or exchange" within the meaning of §1222, but because there was no "sale or other disposition" within the meaning of §1001(a), so that the transaction is not "closed" and the taxpayer may not offset his basis for the property against the amount received. Thus, if a purported "sale" is held to be a "lease," the taxpayer's receipts will be taxed in the same manner (ordinary income, offset by depreciation) whether the property in question is a capital asset or not. It would be more accurate in such a case to hold that there has been no "sale or other disposition"; to say that the transaction does not constitute a "sale or other exchange" may imply, erroneously, that the transaction constitutes a "sale or other disposition" and fails to qualify for capital gain (or loss) treatment only because it does not satisfy the more exacting standards implicit in the term "sale or exchange."

2. *Foreclosure vs. "abandonment."* In Helvering v. Nebraska Bridge Supply & Lumber Co., 312 U.S. 666 (1941), the Court cited the *Hammel* case in holding that a tax sale to foreclose the state's lien for unpaid property taxes was efficacious in bringing the capital loss provisions into play. Both cases have been distinguished, however, from a "voluntary" conveyance of property to the mortgagee by a taxpayer who was not personally liable on the debt, Stokes v. Commissioner, 124 F.2d 335 (3d Cir. 1941), and from an "abandonment" of land to a municipality by a taxpayer who did not wish to pay local taxes thereon, Jamison v. Commissioner, 8 T.C. 173 (1947). The taxpayer having no personal liability in either case, it was held that he received no consideration on the transfer and that this deprived it of the character of a "sale or exchange."

Should there be any tax difference between a foreclosure of a tax or mortgage lien and a "voluntary" abandonment or conveyance to the lienor? Can the taxpayer whose real estate has become worthless take a deduction under §165(a) without abandoning or transferring it so as to avoid even the semblance of a "sale or exchange"? In Helvering v. Gordon, 134 F.2d 685 (4th Cir. 1943), the Commissioner argued that real estate could not give rise to a loss until the taxpayer divests himself of title. Although admitting that in the case of other property, actual worthlessness permits a deduction even though the property is not definitely disposed of, he argued that "real estate always has potential value" so that no closed transaction is shown while the taxpayer continues to own the property. The court said:

> Assuming the truth of this assertion with respect to an unencumbered interest in land, it cannot stand the practical or realistic test which is met when the interest is subject to superior liens or encumbrances that exceed its real value. In such a case the value of the equity is extinguished as effectually as the interest which a stockholder retains who holds title to shares in an insolvent corporation that has no reasonable expectation of recovery. In one case, as in the other, the loss has taken place and the retention of the bare legal title becomes a circumstance without significance. [134 F.2d at 688.]

See also United California Bank v. Commissioner, 41 T.C. No. 44 (1964) (on the facts, no abandonment of vacant building); Hummel v. United States, 227 F. Supp. 30 (N.D. Calif. 1963);Regs. §1.167(a)-8 (recognition of gain or loss on retirement of depreciable property). Is it possible that the equity of the taxpayer in Helvering v. Hammel became worthless before the foreclosure proceedings were instituted?

3. *Worthless securities: §165(g).* Section 165(g) provides that if a "security" (defined to include stock, as well as bonds and other evidences of indebtedness) which is a capital asset becomes worthless during the taxable year, the loss shall be treated as though it has arisen on a sale or exchange. The reason, no doubt, is that a sale of the security just before it became worthless would have created a capital loss (unless the sale could be disregarded as a sham), and there is no good reason to treat the taxpayer differently if he holds the security a little longer. But the statutory parallelism is not perfect:

(a) Section 165(g) applies only to securities issued by corporations or political bodies. A loan to an individual or to a partnership will give rise to a bad debt deduction when it becomes worthless, although a sale before it became worthless would have produced capital loss. This disparity is reduced if the worthless obligation is a "non-business debt" within the meaning of §166(d) (supra p. 290), but even if it is, the taxpayer gets a short-term capital loss, whereas a sale would have produced either a long-term or a short-term capital loss, depending upon the holding period.

(b) Even if the borrower is a corporation or political body, §165(g) does not apply to loans if there is no "evidence of indebtedness" or if the evidence of indebtedness is not coupon-bearing or in registered form. For the meaning of these terms, see Gerard v. Helvering, 120 F.2d 235 (2d Cir. 1941); Lynn v. Commissioner, 15 T.C. 832 (1950) (dissenting opinion); Lurie v. Commissioner, 156 F.2d 436 (9th Cir. 1946) (on the possibility of registering or deregistering at will). When §165(g) is inapplicable, the taxpayer's deduction on worthlessness is governed by §166(a), subject to the restriction of §166(d) if the loan is a "non-business" debt.

(c) When §165(g)(1) applies, the worthless security is treated as though it had been sold

on the last day of the taxable year (presumably because it is difficult enough to determine the year of worthlessness, without endeavoring to pinpoint the day), but this may give the taxpayer a long-term capital loss, although a sale a few days earlier would have resulted in a short-term loss.

(d) Section 165(g) is ordinarily inapplicable if the taxpayer is a domestic corporation and the worthless securities were issued by an "affiliated" corporation. See §165(g)(3), whose purpose is to approximate roughly the treatment that would have been accorded to the loss if it had been incurred directly by the taxpayer. Thus, if a subsidiary was engaged in manufacturing or selling, the parent's loss on its failure will be an ordinary loss, in recognition of the fact that if the operations had been carried on by the parent without the intervention of the subsidiary, the parent would probably have deducted the expenses or losses of the operations from ordinary income. On the other hand, if the subsidiary was engaged in security speculations, the loss on its failure will be a capital loss, conforming to the tax effect that would have been felt if the parent had carried on such operations in its own right. Section 165(g)(3) applies only if the securities of the affiliated corporation become worthless, however, and not if they are sold.

Can §165(g) be avoided, and an ordinary loss obtained, by "abandoning" the securities, either before or when they become worthless?

Several exceptions to §165(g) were created in 1958 by the enactment of §1244 (ordinary loss deduction, up to $25,000 per taxpayer or $50,000 for husband and wife filing joint return, on certain stock of a "small business corporation") and §§1242-1243 (ordinary loss on stock and convertible debentures of company operating under Small Business Investment Act of 1958). All three provisions embrace losses when the securities are sold, as well as when they become worthless. Sections 1242-1243 apply to a very limited class of corporations, but §1244 is of rather general application. See Moore and Sorlien, Adventures in Subchapter S and Section 1244, 14 Tax L. Rev. 453 (1959); Groh, What to Do About Stock of the Small Business Corporation, 37 Taxes 225 (1959).

4. *Payment of a claim or debt by the obligor.* Although Herbert's Estate v. Commissioner, 139 F.2d 756 (3d Cir. 1943), held that a taxpayer who collected a debt from the obligor had engaged in a "sale or other disposition" of his claim within the meaning of §1001(a), it has been held that collection is not a "sale or exchange" so as to warrant capital gain or loss treatment. Hale v. Helvering, 85 F.2d 819 (D.C. Cir. 1936); Fairbanks v. United States, 306 U.S. 436 (1939); see also Fahey v. Commissioner, 16 T.C. 105 (1951) (compromise settlement of claim not a "sale or exchange"); Ogilvie v. Commissioner, 216 F.2d 748 (6th Cir. 1954) (settlement of judgment not a "sale or exchange").

By virtue of §1232(a), however, the retirement of bonds and other evidences of indebtedness (if they constitute capital assets) is treated as a sale or exchange, thus avoiding an unwarranted disparity between a bond that is sold by the holder just before retirement and one that is held until retirement. But the parallel between retirements and sales is not complete:

(a) Section 1232(a) applies only to evidences of indebtedness issued by corporations and political bodies, not to those issued by individuals and partnerships.

(b) Even in the case of corporate and political debtors, §1232(a) applies only to "evidences of indebtedness," not to open account loans and similar claims. Moreover, if the "evidence of indebtedness" was issued before January 1, 1955, §1232(a) applies only if it was issued with interest coupons or in registered form, or was in registered form on March 1, 1954.

(c) Section 1232(a) applies only to amounts received on the "retirement" of a bond or other evidence of indebtedness. If the creditor is paid in a transaction that does not constitute a "retirement," he may realize ordinary income or loss, although a sale of the claim would have produced capital gain or loss.

The general rule of §1232(a) is qualified if the taxpayer realizes gain on an instrument that was issued at a discount, §1232(b), or that was purchased after the detachment of interest coupons, §1232(c). Both provisions are designed to separate the interest component of the taxpayer's gain from the "true" capital gain component, and they are applicable to gain realized on a sale or exchange, as well as on retirement. Supra page 520.

5. *Other transactions between two parties to a contract.* When one of the parties to a contract (e.g., a lease, agency, or distributorship) is paid for relinquishing some or all of

his rights, the courts have often found it difficult to view the transaction as a "sale or exchange," and have sometimes preferred to describe the transactions as a "rescission," "modification," "extinction," etc. The principal cases are cited in Commissioner v. Pittston, supra page 513, and Commissioner v. Ferrer, supra page 519, see also Bisbee-Baldwin Corp. v. Tomlinson, 320 F.2d 929 (5th Cir. 1963); Paul Small Artists, Ltd. v. Commissioner, 37 T.C. 223 (1961); §1241.

6. *"Sale" vs. "license" or "lease."* A long controversy in which the government contended that a taxpayer who received royalties measured by the payor's use of his patent or copyright had "licensed" the patent or copyright rather than "sold or exchanged" it is described supra page 564; see also §1235. Although the government now concedes that many royalty arrangements qualify as sales or exchanges, some do not. See Rev. Rul. 58-353, 1958-2 C.B. 408; supra page 565: Duke, Foreign Authors, Inventors, and the Income Tax, 72 Yale L.J. 1093, 1110-1113 (1963).

Under what circumstances does the disclosure of information for compensation constitute a "sale"? See duPont & Co. v. United States, 288 F.2d 904 (Ct. Cl. 1961) (trade secret); Commercial Solvents Corp. v. Commissioner, 42 T.C. No. 30 (1964).

When an investor in mineral property enters into an arrangement for its exploitation by another person, under which the investor is to be paid on a royalty basis, there are difficult problems of determining whether he has "sold or exchanged" a capital asset, or merely leased it. This question has been previously encountered in connection with the deduction of depletion; in general, if the transaction is a "lease," the taxpayer will realize ordinary income subject to depletion, while if it is a "sale," his income will be taxed as capital gain and the right to a depletion allowance will pass to the purchaser.

See Commissioner v. Southwest Exploration Co., supra page 318; Sneed, The Economic Interest — An Expanding Concept, 35 Texas L. Rev. 307 (1957).

The lease/sale dichotomy has also been encountered in connection with leases with option to purchase (supra p. 249), sale-and-leaseback transactions (supra p. 466), and "bootstrap sales" to impecunious buyers (supra p. 512-513).

As suggested in paragraph 1 of this note, these sale/lease cases may involve the basic question of whether there has been a "sale or other disposition" of the property within the meaning of §1001(a), rather than the narrower issue of "sale or exchange" as used in §1222. If so, the same result (no "closed" transaction) would follow even if the property were not a capital asset.

7. *Liquidations, redemptions, and similar corporate transactions.* If a taxpayer's stock is redeemed by the issuing corporation, or surrendered in the course of a corporate liquidation, the transaction is sometimes treated as a sale or exchange of the stock. If a corporation makes a distribution of its capital, without liquidating, the distribution ordinarily gives rise to a capital gain to the extent that it exceeds the basis of the stock, even though the taxpayer has not engaged in a technical "sale or exchange." These transactions are considered in more detail in Chapter VII.

8. *Miscellaneous transactions.* The refusal of the court in *Hammel* to limit the term "sale or exchange" to voluntary transactions was cited in Hawaiian Gas Products Ltd. v. Commissioner, 126 F.2d 4 (9th Cir. 1942), in holding that there was a "sale or exchange" when the taxpayer's property was taken in condemnation proceedings. Note that §1033 and §1231(a) treat condemnations and sales under threat of condemnation in the same fashion, and that they extend the same treatment to theft and destruction, although the Supreme Court held in *William Flaccus Oak Leather Co.*, supra, that the term "sale or exchange" does not embrace the destruction of insured property by fire.

In Midsouth Gas Co. v. United States, 6 A.F.T.R.2d 5198 (E.D. Ark. 1960), the issue was whether a contract for furnishing and installing pipe was primarily a sale of pipe and only incidentally an agreement for its installation, or vice versa. The jury found that the transaction was a sale, and that the taxpayer's entire profit was attributable to the sale, producing long-term capital gain.

In addition to the statutory provisions already mentioned that dispense with the necessity of a "sale or exchange" or treat borderline transactions as qualifying, the following may be noted: §1234 (loss on the lapse of an unexercised option); §1240 (amounts received for release of rights under certain long-term employment contracts); §1233(a) (delivery of property to close a short sale); §631(a) (cutting of timber); and §631(c) (coal royalties).

Was there a "sale or exchange" of the gas cylinders in the *duPont* case, supra page 494? If not, were they "involuntarily converted" within the meaning of §1231(a)?

Note that a "sale or exchange" was not required in the *Arrowsmith* case, supra page 582; the transaction before the court was held to produce a capital loss because it was intimately related to an earlier transaction that was treated as a sale or exchange.

9. *Anticipatory sales on the eve of receiving ordinary income.* For the legal effect of anticipatory transactions, in which a capital asset is sold just before, and to avoid, an event that would not constitute a "sale or exchange," see page 527 supra; see also Jones v. Commissioner, 40 T.C. 249 (1963), and cases there cited.

10. *Reference.* Note, The Elements of a Section 117 "Sale or Exchange," 53 Colum. L. Rev. 976 (1953).

Section K. Holding Period

DYKE v. COMMISSIONER
6 T.C. 1134 (1946)

[The taxpayer purchased 625 shares of Campbell Transportation Company stock at a cost of $150,000 on March 6, 1940, and sold this stock in 1941 for $262,000, thus realizing a gain of $112,000. The Internal Revenue Code of 1939 contained a graduated "holding period" for capital assets, under which 100 per cent of the taxpayer's gain was "taken into account" if the property was held for more than 18 months, 66⅔ per cent if it was held for more than 18 months but not more than 24 months, and 50 per cent if it was held for more than 24 months.* The taxpayer included only 66⅔ per cent of his gain in gross income, and a deficiency was determined on the ground that 100 per cent of the gain should have been included. The stock was sold under an agreement dated March 10, 1941, between the shareholders of Campbell Transportation Company (represented by Charles T. Campbell), as sellers, Mississippi Valley Barge Line Company, the buyer, and Mercantile Bank & Trust Company of St. Louis (as escrow agent). The issue before the court was the date on which the taxpayer's "holding period" ceased under the agreement.]

Mississippi Co. and Campbell Transportation Co. were both subject to the jurisdiction of the Interstate Commerce Commission under the provisions of the Transportation Act of 1940.

The agreement provided in part as follows:

4. The consummation of the sale and purchase and the respective obligations of the parties hereunder shall be conditional upon the granting to Buyer of authority to make such purchase by the Interstate Commerce Commission, under the provisions of the Transportation Act of 1940, on or before September 22, 1941. . . . If the Sellers or the Buyer, as the case may be, shall fail promptly and diligently to perform their or its covenants herein set forth, then the other party or parties, as the case may be, shall have the right forthwith to cancel and terminate this Agreement in its entirety. . . .

5. When and if the Interstate Commerce Commission shall have entered an order authorizing the purchase by the Buyer of the shares of stock to be purchased under this Agreement, the Buyer shall forthwith give notice of the entry of such order to Charles T. Campbell, as representative of the Sellers. As used in this Agreement, the term "Closing Date" means the last day of the month during which Buyer shall have given such notice and the term "Delivery Date" means the date on which the sale is to be consummated and the purchase price is to be paid, viz., the 10th day of the month following the Closing Date.

. . .

* Since 1942, the Code has distinguished only between short-term and long-term transactions, the dividing line being 6 months. — Ed.

6. Buyer's obligations under this Agreement shall be conditioned upon
(a) The delivery to the Buyer on or before the Delivery Date of the following:
1. Evidence that Campbell Transportation Co.'s obligations do not exceed those shown on the balance sheet of November 30, 1940, with certain exceptions.
2. Evidence that the financial position of the Campbell Transportation Co., as of the closing date, is not materially adversely different from that shown by the balance sheet of November 30, 1940, provided, however, that the payments of dividends of $20 per share, the payment of dividends allowed by paragraph 5, nor obligations incurred under paragraph 6-1-a of the agreement shall not be deemed to adversely affect the financial position.

Then follow five other items, and then:

Sufficient evidence that Campbell Transportation Company has, on or before Closing Date, done any and all things necessary to prevent the waiver or lapse or loss of any rights which the Company may have had under the so-called Grandfather Clause of Part III of the Transportation Act of 1940.

In addition to these things, the buyer's obligation under the agreement was conditioned upon a favorable opinion of buyer's counsel as to the title of Campbell Transportation Co. to all property, real or personal, purported to be owned by it.

Paragraph 8 of the agreement provided:

In the event the Commission shall have entered an Order authorizing the purchase and on the Delivery Date such Order shall have been vacated, rescinded, annulled or set aside, temporarily or permanently, by action of the Commission or of a court of competent jurisdiction, then this Agreement shall in like manner terminate, all obligations hereunder shall cease and the Escrow Agent shall take the action hereinbefore set forth, unless the Buyer shall, on such Delivery Date, by written notice to Charles T. Campbell, as representative of the Sellers, and to the Escrow Agent, elect to complete the purchase on such Delivery Date without regard to the status of such Order on such date.

Paragraph 9 of the agreement specified the mechanics by which the sellers should deposit their stock with the escrow agent, and prescribed the form of receipt to be issued by such escrow agent.

Paragraph 9 (b) required the buyer to furnish the escrow agent on or prior to delivery date, the funds with which to make payment for the shares of the stock deposited, and then provided:

. . . and if all the conditions set forth in this Agreement shall have occurred on or prior to said Delivery Date, the Escrow Agent shall, at eleven o'clock in the forenoon, Central Standard Time, on the Delivery Date, forthwith distribute, to or upon the order of each Seller and against the surrender of the receipt theretofore issued by the Escrow Agent in respect of the certificate or certificates deposited by such Seller, the amount of the purchase price herein specified for such shares, and shall also deliver to the Buyer all of the deposited certificates, endorsed for transfer as hereinbefore provided. If said conditions shall not have occurred on or prior to said Delivery Date, the Escrow Agent shall forthwith return to or upon the order of each Seller and against the surrender of the receipt issued therefor, the certificate or certificates theretofore deposited by such Seller and shall release to the Buyer the funds deposited by it pursuant to this subparagraph (b).

Paragraph 11 authorized and empowered Charles T. Campbell, as the representative of the sellers:

. . . to enter into such agreements with Mississippi Valley Barge Line and the Escrow Agent as the said Charles T. Campbell shall consider to be for the best interests of the Sellers, for the purpose of supplementing, extending, modifying or amending this Agreement; provided, however, that the said Charles T. Campbell shall have no authority to

(a) extend the Delivery Date beyond December 10, 1941; (b) make any agreement which shall impose any additional obligations on the Sellers, or any of them; (c) diminish the purchase price specified in paragraph 3 hereof, except for minor adjustments for taxes, transfer stamps, etc., or (d) waive the right of the Sellers to cause the declaration and payment of dividends as provided in paragraph 5 hereof. . . .

The agreement dated March 10, 1941, was promptly executed by all parties concerned and the approval thereof by the stockholders of the buyer was had on March 26, 1941. Thereupon Campbell Transportation Co. gave notice to each of its stockholders that the Mississippi Co. stockholders had approved the contract and that it would be in order for the stockholders to deposit their respective shares of stock with the escrow agent. The petitioner deposited his stock on April 1, 1941, and received his receipt from the escrow agent dated April 4, 1941.

Application was promptly made by Mississippi Co. to the Interstate Commerce Commission for approval of the purchase by it of the Campbell Transportation Co. stock. Hearings were held and the case submitted to the Commission. The months of May and June, and more than 30 days of July, elapsed without any intimation being given by the Interstate Commerce Commission as to when the decision could be expected.

In the afternoon of July 31, 1941, an officer of Mississippi Co. appeared at Campbell's office and advised him that the Interstate Commerce Commission had rendered its decision authorizing the purchase by the Mississippi Co. of the shares of stock in question. July 31, 1941, fell on Thursday. The notice was received so late in the afternoon that nothing could be done on that day, and in the following ten days two Saturdays and two Sundays intervened.

Under the terms of the agreement the closing date was July 31, 1941, and the delivery date was August 10, 1941. During that ten days the books of Campbell Co. had to be closed for the month of July and a statement of its earnings up to July 31 made available to both Mississippi Co. and Campbell Transportation Co. Its business was scattered along the Ohio and tributary rivers, also the Mississippi River and some of its tributaries. It operated a large number of barges and carried freight in large and small quantities for whomsoever desired shipment on those waters. It was impracticable, if not impossible, for the Campbell Transportation Co. to close its books within ten days, and furnish other information required. In these circumstances Charles T. Campbell, representing the sellers, requested an extension of the delivery date from August 10 to September 10, 1941. In his letter he stated in part as follows:

In order to induce you to make this necessary extension, the undersigned, for himself and the other stockholders, herewith agrees with you as follows:

1. The extension will extend the Delivery Date only and will not extend the "Closing Date" specified in the aforesaid agreement or in any other manner affect or prejudice your rights thereunder.

2. The directors of Campbell Transportation Company will cause a dividend to be declared, in an amount equal to the net earnings of the company, as defined in Paragraph 5 of the aforesaid agreement, for the period beginning January 1, 1941, and ending July 31, 1941, to the extent that such net earnings exceed $30.00 a share (representing the $20.00 limitation set forth in said Paragraph 5, plus $10.00 a share already declared and paid out of such net earnings). Said dividend will be payable to present stockholders of the company and will be paid, if practicable, on or before September 10, 1941.

3. At your request, the present directors of the company, viz., Charles T. Campbell, A. E. Dyke, Harry J. Steele, Kenneth G. Jackson and John E. Laughlin, Jr., will tender their resignations and the directors or the present stockholders of the company will elect successor directors acceptable to you.

The buyer readily granted an extension of the delivery date as requested. . . . All of the conditions of the escrow agreement had been complied with to the satisfaction of the buyer on September 10, 1941, and on that date the buyer paid for and received the shares of stock held by the escrow agent. . . .

Opinion

Smith, Judge: The narrow question presented by this proceeding is the period of holding by the petitioner of his 625 shares of Campbell Transportation Co. stock. Both parties are in agreement that he purchased the shares on March 6, 1940. They are in disagreement as to the date of the sale of the stock, the petitioner contending that the sale was made on September 10, 1941, and the respondent that it was made on July 31, 1941, the date upon which the Interstate Commerce Commission approved the application of the Mississippi Co. to purchase all the shares of stock of Campbell Transportation Co. . . .

It is the position of the respondent that substantially all of the conditions of the escrow agreement, aside from the actual payment of the cash by the Mississippi Co., had been fulfilled or could have been fulfilled on or before August 10, 1941, and that the extension of the delivery date to September 10, 1941, was made for the purpose of making it possible for the petitioner and the other stockholders, who had purchased their stock at the same time that petitioner had purchased his, to claim that the gains made by them on the sales of their shares were long term capital gains rather than short term capital gains. We are convinced from a careful consideration of all of the evidence in this case that the request for the extension was not for the purpose of accommodating the petitioner and the other stockholders. In point of fact, petitioner had no voice whatever in obtaining an extension of the delivery date.

There can be no question that where a person agrees to sell property, subject to certain conditions, and the property is placed with an escrow agent who holds the property until the conditions have been fulfilled, no sale is effected unless and until those conditions have been fulfilled. In Texon Oil & Land Co. v. United States, 115 Fed. (2d) 647, and Big Lake Oil Co. v. Commissioner, 95 Fed. (2d) 573, both involving the transfer of corporate stock through an escrow agreement, it was held that the transferee did not receive the stock until the delivery out of escrow on the ground that the conditions upon which the escrow was premised were not completed until then. See also McLaughlin v. Commissioner, 113 Fed. (2d) 611; Howell v. Commissioner, 140 Fed. (2d) 765; certiorari denied, 322 U.S. 735. In the last named case an escrow agreement and capital gain tax were involved. The taxpayer contended a "long term," and the Commissioner a "short term," capital gain had been realized. The taxpayer and one Ferguson entered into an escrow agreement on October 6, 1937, whereby Ferguson agreed to lease certain land to the taxpayer, provided oil drilling was commenced on the land by November 21, 1937. The drilling of the well was begun on November 16 or 17, 1937, and on the same day the lease was delivered out of the escrow to the taxpayer. On April 10, 1939, the taxpayer sold his interest in the lease for a substantial profit. The court held that no interest in the lease was obtained by the taxpayer until the delivery out of the escrow on November 16 or 17, stating with respect to the interest he acquired on October 6, 1937, as follows:

> . . . But all that he had on that day was a contractual right to have a lease issued to him if and when he should comply with the terms and conditions of his contract. Taxpayer fails to recognize the difference between the absolute and the conditional. Prior to

the starting of the well the lease was purely conditional, and would become absolute upon the compliance with the conditions. The parties traded with this thought in view. Taxpayer, doubtless, had this thought in mind when he made a contract of sale of a portion of his interest in the contract to the Consolidated Oil Company before the lease was delivered and then, upon the delivery of the lease, made an absolute assignment of the interest he had theretofore contracted to sell. In Norman v. Wilson, 41 S.W. 2d 331, the Court of Civil Appeals of Texas, Austin Division, held that a grantee was not entitled to delivery until he had fulfilled the conditions imposed by the escrow agreement, and that the placing of a conveyance in escrow to be delivered upon the performance by the grantee of certain conditions passed no title to the property until delivery.

In Lucas v. North Texas Lumber Co., 281 U.S. 11, the lumber company had granted a ten-day option to purchase timber lands. The purchaser, on November 30, 1916, gave notice that it would exercise the option and pay the purchase price as soon as papers were prepared. The vendor did not prepare the necessary papers to effect the transfer or demand the purchase price in 1916, but delivered the necessary papers on January 5, 1917, when the transaction was finally closed. The lumber company claimed that the profit was realized in 1916 and represented taxable income of that year. The Supreme Court held otherwise, however, and stated:

An executory contract of sale was created by the option and notice, December 30, 1916. In the notice, the purchaser declared itself ready to close the transaction and pay the purchase price "as soon as the papers were prepared." Respondent did not prepare the papers necessary to effect the transfer or make tender of title or possession or demand the purchase price in 1916. The title and right of possession remained in it until the transaction was closed. Consequently unconditional liability of vendee for the purchase price was not created in that year. . . .

In the instant case it is clear that the Mississippi Co. had no legal obligation to pay the purchase price for shares of stock of the Campbell Transportation Co. until all of the conditions of the escrow agreement had been complied with. They were not complied with prior to September 10, 1941. One of the terms of the escrow agreement was that the shares of stock should be held by the escrow agent until it received payment for the shares. This is an ordinary condition of an escrow agreement. It was plainly the intention of the parties, as shown by the escrow agreement, that the sale was not to be consummated until the delivery date. Paragraph 5 of that agreement stated:

. . . As used in this Agreement, the term "Closing Date" means the last day of the month during which Buyer shall have given such notice and the term "Delivery Date" means the date on which the sale is to be consummated and the purchase price is to be paid, viz., the 10th day of the month following the Closing Date.

There is clearly no ground for the respondent's contending in this proceeding that the "Closing Date" or any other date prior to the "Delivery Date" was that on which the sale was consummated. The delivery date was postponed in accordance with the escrow agreement.

We hold that the petitioner held his 625 shares of Campbell Transportation Co. stock for a period of more than 18 months. . . .

NOTE

1. *Property "held" by the taxpayer.* Would the result have been different if the buyer had deposited the purchase price in cash with the escrow agent at the same time (April, 1941) that the sellers deposited their shares? If dividends paid between the date of the agreement and the "delivery date" were to be credited against the sales price? See Barton,

Taxation of Interim Income in Agreements of Sale, 1958 So. Calif. Tax Inst. 689. If in a desire to extend the holding period for their shares, the shareholders had in the original agreement specified September 10, 1941, as the delivery date?

In citing the *North Texas Lumber Co.* case, did the court assume that the holding period for a capital asset terminates at the same time that gain or loss is realized, and vice versa? Is the holding period affected by the taxpayer's accounting method, or by the doctrine of constructive receipt (infra p. 780)? See Kuehner v. Commissioner, 214 F.2d 437 (1st Cir. 1954). If the property transferred in the *Dyke* case had been depreciable, would the taxpayer's right to deduct depreciation terminate, and the buyer's right commence, on September 10, 1941, rather than earlier?

For tax-motivated escrow arrangements that successfully extended the taxpayer's holding period, see First American National Bank v. United States, 209 F. Supp. 902 (M.D. Tenn. 1962); Watson v. Commissioner, ¶49,089 P-H Memo T.C.; Note, The Effect of Escrow Arrangements on Federal Income Tax Liability, 59 Harv. L. Rev. 1292 (1946).

See generally Merrill v. Commissioner, 40 T.C. 66 (1963), and cases there cited; Swenson v. Commissioner, 309 F.2d 672 (8th Cir. 1962); Rev. Rul. 54-607, 1954-2 C.B. 177.

For problems in determining when a condemnation of the taxpayer's property occurs, see Wendell v. Commissioner, 326 F.2d 600 (2d Cir. 1963).

If stock is acquired at different dates and taxpayer sells some of the shares but cannot ascertain their holding period, the rules for determining basis (supra p. 451) also govern the holding period. Regs. §1.1223-1(i).

2. *"More than 6 months."* Long-term gain or loss is realized only if the asset is held for "more than 6 months," a requirement that taxpayers sometimes fail to satisfy because they erroneously think that precisely six months will do, or because they do not realize that the holding period begins the day *after* the day of acquisition. See Fogel v. Commissioner, 203 F.2d 347 (5th Cir. 1953) (property bought on June 19 and sold on December 19 was not held for "more than 6 months"); Rev. Rul. 54-607, 1954-2 C.B. 177; I.T. 3985, 1949-2 C.B. 51.

In the case of transactions in stock or securities effected through a broker on an organized securities exchange, the customer's order is executed on a "contract" or "trade" date, with delivery and payment postponed for several days to the "settlement date." It is the former date that controls for tax purposes; the customer's holding period begins the day after the purchase order is executed and ends on the day the sale order is executed. I.T. 3705, 1945 C.B. 174. In the case of year-end sales, the taxpayer's *holding period* may end on December 30 or 31, but if he is on the cash basis his gain will not be realized until January, when the cash is first available to him. If the taxpayer wants to recognize the transaction in December, he can instruct his broker to make a "cash" or "next day" sale, rather than a "regular way" sale.

3. *Short sales and the holding period.* Section 1233(b), derived from a provision added in 1950, was designed to take the profit out of several practices previously employed to outwit the holding period. Example (1) of Regs. §1.1233-1(c)(6) illustrates the problem. Note that on July 1 the taxpayer has an unrealized profit of $600, which would constitute a short-term gain if realized at that time. By selling short on July 1 (a so-called "sale against the box," i.e., a short sale of stock he already owns), he immunizes himself against any subsequent fluctuations of the market, since any increase in the market value of the stock bought in February will be counterbalanced by an equal unrealized loss on his "short" position. Conversely, a decline in the market value of the stock will improve his "short" position at the expense of his "long" position. Since the taxpayer is thus no longer at the risk of the market after July 1, §1233(b) treats his profit as short-term (February 1 to July 1), no matter when he closes out his positions by making delivery. Before §1233(b) was enacted, the taxpayer would have claimed a long-term capital gain of $600 on the theory that he sold his February stock on August 2, when he delivered it to satisfy his short position.

Other applications of §1233(b) may be studied in the examples given in the Regulations. Some of the transactions against which §1233(b) was aimed are comprehensible only if one recalls that before 1951 long-term capital gains and losses were "taken into account" only to the extent of 50 per cent, while short-term gains and losses were "taken into account" in full. This meant that a taxpayer with a long-term gain of $200 and

a short-term loss of $100 would break even for tax purposes. Some of the manipulations with short sales and similar devices were designed to produce this happy combination of long-term gains and short-term losses. See Brach, Investor Short Sales, 11 N.Y.U. Inst. on Fed. Taxation 1 (1953); Mim. 6243, 1948-1 C.B. 44; Mim. 6789, 1952-1 C.B. 38; Deal v. Morrow, 197 F.2d 821 (5th Cir. 1952).

4. *Inherited property.* Even though the distribution of property acquired by bequest from a decedent may be delayed until administration of the estate is completed or until a testamentary trust terminates, the heir's holding period begins on the date of death if the property was owned by the decedent, or on the date of purchase if it was purchased by the executor or testamentary trustee. Helvering v. Gambrill, 312 U.S. 11 (1941).

5. *"Tacked" holding period.* In computing his holding period for an asset, the taxpayer is often allowed by §1223 to add ("tack on") the time he held other property or the time another taxpayer held the same or other property, ordinarily because the property disposed of has a "substituted" basis. Thus, if the taxpayer receives a tax-free stock dividend, his holding period for the dividend shares is dated from his acquisition of the original shares; the donee's holding period for property received by gift and sold at a gain commences with the donor's acquisition of the property; and the holding period for securities whose acquisition required the taxpayer's loss on similar securities to be disallowed under §1091 ("wash" sales) includes his holding period for the similar securities. In a similar vein, §1223(1) provides in general terms that the holding period of property acquired in a tax-free exchange (e.g., a "like kind" exchange under §1031) includes the taxpayer's holding period for the property given up in the exchange, subject to a qualification — not applicable to other "tacked" holding periods under §1223 — that the original property must have been a capital asset or §1231 property at the time of the exchange.

Note that a taxpayer who acquires stock by exercising a stock right may not "tack" the holding period of the stock right to the holding period of the stock itself. §1223(6). The same principle is applicable to the acquisition of other types of property by the exercise of an option. See Helvering v. San Joaquin Fruit & Investment Co., 297 U.S. 496 (1936); Milliken v. Commissioner, 196 F.2d 135 (2d Cir. 1952), cert. denied, 344 U.S. 884 (1952). This means that the sale of property immediately after it has been acquired by the exercise of an option is a short-term transaction, although the same profit might have been realized as long-term gain by selling the option. See Chemetron v. Commissioner, 299 F.2d 644 (7th Cir. 1962) (transaction construed as sale of option, rather than as exercise of option followed by sale of assets).

6. *"Split" holding period.* If a number of assets are sold at the same time (e.g., as in Williams v. McGowan, supra p. 570), the holding period is computed separately for each asset. If the taxpayer sells property that has been recently constructed or that is still under construction, the holding period may be "split," i.e., computed separately for each of the major components of the property. Paul v. Commissioner, 206 F.2d 763 (3d Cir. 1953); Williams v. Commissioner, 285 F.2d 582 (5th Cir. 1961); Rev. Rul. 62-140, 1962-2 C.B. 181 (split holding period for stock acquired on surrender of debentures and payment of cash; part of gain or loss on each share of stock is allocated to a holding period beginning with acquisition of the debentures and balance is allocated to a period commencing with acquisition of the stock). Query: does goodwill have a split holding period if some of its value is attributable to the taxpayer's recent activities?

7. *References.* Sultan, The Capital Gains "Holding" Dilemma, 16 Vand. L. Rev. 535 (1963); Young, Tax Problems in Real Estate Transactions, 1949 Ill. Law Forum 473; Dibble, Current Problems in Determining Holding Period, 1951 So. Calif. Tax Inst. 359.

CHAPTER 7

The Corporation and Its Stockholders

SECTION A. INTRODUCTORY

GOODE,* THE POSTWAR CORPORATION TAX STRUCTURE †

In How Should Corporations Be Taxed?
46-58 (1947)

Criticisms of the present corporate income tax and suggestions for its revision center largely around the so-called "double taxation" of distributed corporate profits. Corporations now pay a tax on their profits, and stockholders pay a personal income tax on dividends received. Most plans for reform of the present method of taxing corporations are intended to reduce or eliminate this so-called "double taxation" of distributed profits.

NATURE OF THE PROBLEM OF "DOUBLE TAXATION" OF CORPORATE PROFITS

For a number of reasons I believe that the use of the term "double taxation" is unfortunate. In the first place, the emotional content of the words "double taxation" is enough to condemn the present system in the minds of most people without further hearing. It may be that the present method of taxing corporate profits should be fundamentally revised, but the issue should be argued out fully and carefully and not decided on the basis of colorful phrases. In the second place, the real problem seems to me not to be "double taxation" in the sense of simultaneous imposition of two taxes but how the taxation of corporate profits and stockholders compares with taxation of other kinds of income and other income recipients.

Under the present system, the corporate tax strikes profits distributed to stockholders not subject to individual income tax, either because of low-income or tax-exempt status, although other income going to the same income recipients is not taxed. In this case dividends are taxed more heavily than other kinds of income even though there is no double taxation in the literal sense. On the other hand, profits retained in corporations controlled by high-income stockholders may bear a smaller current tax than other income under the control of the same individuals.

It seems to me that discussion would be advanced by substituting for "double taxation" such colorless terms as "relative overtaxation" or "relative undertaxation." Instead of talking about removal of "double taxation," it seems better to speak of equalizing taxes on corporate profits and other kinds of income. Whether one finds a specific proposal acceptable may well depend on whether one is more

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* Economist, Division of Tax Research, U.S. Treasury Department. Opinions expressed are personal views and do not necessarily reflect the official views of the Treasury Department. This paper is based largely on a study entitled The Postwar Corporation Tax Structure, released by the Treasury Department, Division of Tax Research, December 6, 1946.

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concerned with eliminating "double taxation" in the literal sense or with equalizing taxes on different kinds of income.

Several charges have been brought against the present so-called "double taxation" of corporate profits or, as I should prefer to say, the present relative overtaxation of corporate profits. The first charge is that the present system is inequitable. The first principle of equity in taxation is often held to be to tax all natural persons with the same income at the same rate. By this standard it is indeed true that stockholders are often overtaxed. At other times, however, many stockholders are at least temporarily undertaxed. The rule of equal taxation of equal incomes is subject to modification in accordance with the principle of reasonable classification.

It may be argued in support of the present system that differences in taxation of stockholders and other income recipients are a reasonable reflection of genuine differences between stockholders and others. Within the limits of this paper, I cannot pretend to dispose of this issue. A complete discussion of it would, in my opinion, require a thoroughgoing analysis of the corporate income tax and its far-reaching effects on the distribution of income and wealth, on consumption and saving, on incentives and investment, and on employment and national income.

A second charge against the present corporate tax system is that it reduces the incentive to invest and thus reduces national income or slows its growth. In large part, I believe, this criticism is actually a complaint against income taxes in general rather than against the corporate income tax in particular. If, however, corporate profits are taxed more heavily than other kinds of income, the corporate tax may be especially harmful to investment.

In connection with investment incentives it should be noted that the present "double taxation" or "relative overtaxation" of distributed corporate profits is greatest in the case of low-income stockholders and least in the case of high-income stockholders. This is true because the progressive rates of the individual income tax partly offset the effect of the corporate tax on the distributed part of profits. In the case of profits distributed to high-income stockholders who are subject to high individual tax rates, the tax collector would get a much bigger cut at the individual level if he did not get so much at the corporate level. For example, only 30 cents out of each dollar of the corporate tax on profits distributed to a stockholder subject to a 70 per cent marginal individual rate is net revenue to the Treasury or net additional tax on the stockholder's equity. But, 81 cents out of each dollar of corporate tax is net additional tax in the case of profits distributed to a stockholder subject to only a 19 per cent individual rate.

Two other charges against the present method of taxing corporations, which seem to me somewhat less important than those already mentioned, also stem from the present so-called "double taxation" or "relative overtaxation" of distributed profits. The present tax system is held to favor debt financing as compared with equity financing and to discourage the corporate form of doing business.

I shall not atempt to evaluate these charges nor even to state the counterarguments in favor of the present corporate tax. I do want to say that I think that none of the arguments on either side can be accepted uncritically and that, in my opinion, a great deal more analysis needs to be done on the questions raised. For present purposes it is enough to point out that the validity of the case against the present corporate tax depends in large measure on the actual extent of "double taxation" or "relative overtaxation" of corporate profits as compared with other kinds of income.

The present relative overtaxation of corporate profits is neither so extensive nor so heavy as might be supposed on the basis of superficial examination. Unfortunately, however, it does not seem possible at the present stage of economic analysis

to set definite limits to the actual extent of existing relative overtaxation of corporate profits. This is true mainly because we do not know with any degree of certainty who actually pays the present corporate tax. If the tax is passed forward to consumers in the form of higher prices or backward to workers in the form of lower wages, as many believe, stockholders may not be taxed more heavily than other income recipients. To the extent that the corporate tax is shifted forward in higher prices, it is no more a "double tax" on stockholders than, say, the excises on alcoholic beverages are double taxes on stockholders in distilleries, breweries, and wineries. If, and to the extent that, the corporate tax is shifted, it becomes in effect a broad consumption tax and must be so appraised.

Economic and business opinion is divided on the critical issue of shifting.* In deed, the division of opinion goes so deep that sometimes the same individual or group advances arguments that seem conflicting because of inconsistent treatment of the subject of incidence. Without going fully into the subject, I wish only to raise the question of shifting of the corporate tax as a possible limitation on the validity of the criticisms against the tax and as a point that may be pertinent to the appraisal of the various proposals for modifying the present system.

Even if the corporate tax is not shifted to commodity prices or wages, present stockholders may in many cases largely escape the tax. The basis for this assertion is the familiar theory of tax capitalization and amortization. If present stockholders bought their shares with the expectation that the corporate tax would continue, they probably took the tax into account in deciding how much to pay for stocks. Probably stock prices decreased or did not rise as much as they otherwise would have. Present stockholders in many cases may have bought their shares at prices and yields that at least in part discounted the tax. To the extent that they did so, the corporate tax was transformed into a one-time levy on the previous owners of stock, and its unexpected repeal or reduction would give present stockholders windfall gains. It is, of course, impossible to appraise this possibility in quantitative terms.

Furthermore, the effect of the corporate tax has probably not been confined to stock prices but probably has spread to all kinds of earning assets. As stocks became a less attractive investment after imposition or increase of the corporate tax, some potential investors probably attempted to shift to bonds and other assets. The result was doubtless that the prices of bonds and other assets were bid up to some extent, while the fall of the price of stocks was somewhat cushioned. If this happened, the corporate tax was the cause of a general decrease in yields of all kinds of earning assets rather than merely a tax on the yield of stocks.

Problems in Shifting to a New Method of Taxing Corporate Profits

One important problem in shifting to a new method of taxing corporate profits would be to prevent or to minimize tax postponement and avoidance on the part of stockholders. Few critics would suggest outright repeal of the corporate tax without any other change. Such action would open the way for stockholders to escape or postpone personal taxes on their part of undistributed corporate profits. With present low tax rates on long-term capital gains, the opportunities for tax avoidance would be especially tempting. If corporate savings were exempt from taxation, other savings could not in fairness be taxed. But exemption of savings would transform the income tax into a spendings tax, which would be a drastic remedy for any existing "double taxation" or relative overtaxation of dis-

* For a review of the theories, see Ratchford and Han, The Burden of the Corporate Income Tax, 10 Nat. Tax J. 310 (1957). — Ed.

tributed corporate profits. Consequently, most suggestions for revision of the corporate tax contemplate keeping a tax on retained corporate profits while decreasing present taxes on distributed profits.

Another transitional problem in adoption of a new method of taxing corporate profits would be to minimize possible windfall gains to present stockholders. If a new tax system resulted in lower taxes on corporate profits than the securities markets had generally anticipated, windfall gains could not be wholly avoided. If it is true that the effect of the corporate tax has spread to the prices and yields of all kinds of assets, windfall gains for stockholders would be accompanied by windfall losses for owners of bonds, real estate, and perhaps other earning assets. While such windfall gains and losses could not be wholly avoided, their impact might be softened and their secondary effects lessened by spreading the tax adjustment over a period of years.

Approaches to Equalization of Taxes on Corporate Profits and Other Kinds of Income

Partnership Approach. The partnership approach carries to its logical conclusion the view that there is no genuine distinction between corporations and their stockholders, which is implicit in many criticisms of the present corporate tax. The partnership approach would eliminate the corporate income tax and would tax stockholders on their proportionate part of corporate profits when earned whether the profits were distributed or retained by the corporation. Presumably, stockholders would also be allowed to take account of their proportionate part of corporate losses. The partnership approach would completely eliminate any "double taxation" of corporate profits and would completely equalize taxation of corporate profits and other kinds of income. No stockholder's personal tax liabilities would ever be affected by the dividend policy of the corporation. In this respect, the partnership approach is an ideal system against which other proposals for equalizing taxes on corporate profits and other income must be measured.

But from a practical point of view it seems very doubtful that the partnership approach would be an "ideal" system. It seems extremely doubtful that the partnership technique could be successfully applied to big corporations with many stockholders and complicated capital structures. Aside from the work required to allocate earnings among thousands or hundreds of thousands of stockholders, the partnership method would involve the almost insoluble problem of distributing profits according to the different kinds of claims represented by a hierarchy of securities.

I am not prepared to say whether the partnership method would be feasible and appropriate for small corporations.* It does seem to me, however, that as a general method the partnership approach must be regarded as an ideal to be approximated rather than a goal to be reached. I hasten to say that it is an "ideal" only in the sense of equalizing taxes on corporate profits and other kinds of income. Saying that a corporation is nothing more than a sophisticated partnership does not make it so. Personally, I want to leave open the question whether elimination of special taxes on corporate profits is desirable in the light of all relevant equity and economic considerations.

Adjustment at the Corporate Level. Another approach that has been suggested to the equalization of taxes on corporate profits and other kinds of incomes is to grant corporations a tax credit when they pay dividends or to exclude all or

* Subchapter S, enacted in 1958 to permit such an election, is discussed in Section M of this chapter, infra pages 740 et seq. — Ed.

part of dividends paid from taxable corporate income. Stockholders would pay the usual personal taxes on dividends when received. This approach would continue a corporate tax on retained profits but would reduce or eliminate the corporate tax on distributed profits. The corporate tax on retained profits would be intended to minimize possibilities for stockholder tax postponement or avoidance, but it would relatively overtax the part of retained profits allocable to low-income stockholders. If a full tax credit or exclusion were allowed corporations for dividends paid, this system would approach the partnership ideal as closely as any other leading proposal.

The dividends-paid-credit approach could practically eliminate the present premium on debt financing and the present tax discrimination against the corporate form of doing business. The approach would also lower any tax barriers that may now exist to corporate investment. It would be well calculated to counteract any tendency of corporations to shift their taxes to consumers and wage earners.

Another characteristic of the dividends-paid-credit approach may be considered either an advantage or a disadvantage depending on one's point of view. This approach would probably stimulate corporations to pay larger dividends. Management and stockholders would see that taxes could be lowered by increasing dividends. Some observers fear that a tax inducement to distribution of profits might lead corporations to deprive themselves of needed funds and so reduce investment. Others believe that investment is better allocated if submitted to the test of the capital market than if financed by retained earnings. This is another issue that is too broad to be disposed of within the limits of this paper. Perhaps I should emphasize, however, that, while a tax credit for dividends paid might *induce* some corporate managements to be imprudent, it would never *force* them to be so. A corporation could retain as much profits under a dividends-paid-credit plan as under any other plan that imposed a similar tax rate on retained profits. Moreover, it would be possible under the dividends-paid-credit approach to recognize the special capital-raising problems of small corporations by treating a limited amount of profits as if distributed even though retained.

Administration of the dividends-paid-credit approach would be rather simple, since all adjustments would be made at the corporate level.

Adjustment at the Individual Level: Withholding approach. The withholding approach would consider all or part of the corporate tax as a withholding tax or an advance payment on the liabilities of stockholders. Corporations would continue to pay a tax on both distributed and undistributed profits, but dividend recipients would be allowed to take credit for the tax paid by the corporation on their share of distributed profits. Dividends recipients would include in their taxable income cash received plus withholding tax but would get credit for the withholding tax. If the amount withheld by the corporation exceeded the stockholder's personal tax liability, he would get a refund from the Treasury. This system, which is used in Great Britain, would be somewhat similar to the present method of withholding on salaries and wages.

The withholding approach would be closely similar to the dividends-paid-credit approach except for making the tax adjustment at the individual rather than the corporate level. Both approaches could completely equalize taxes on distributed corporate profits and other forms of income. Taxes could be entirely eliminated on dividends going to nontaxable stockholders and the same tax imposed on other dividends as on interest and other kinds of income. Both approaches would continue a tax on retained corporate profits in order to reduce individual tax postponement or avoidance.

The withholding approach could reduce or practically eliminate the tax discrimination against equity financing and against the corporate form of organiza-

tion. In the long run it might counteract any tendency for the corporate tax to raise prices and lower wages, but in the short run the withholding approach would be less likely to eliminate the tax as a factor in price and wage decisions than would a tax adjustment at the corporate level.

If corporate officials and stockholders acted quite rationally, the withholding approach should have the same effect on dividend policy as the dividends-paid-credit approach. In both cases stockholders could gain the advantages of the plan only if profits were distributed. Perfectly rational stockholders would bring as much pressure on management to distribute profits under one plan as under the other. It must be admitted, however, that, given present management and stockholder psychology, the withholding approach would probably be a less powerful stimulus to increased dividends than a dividends-paid-credit plan.

A withholding system would raise some rather troublesome administrative problems, but probably no insuperable ones. For example, it would be necessary to trace dividends back to the corporate income from which paid in order to determine how much tax credit for withholding to allow stockholders. It would also be necessary to grant every dividend recipient a proper tax credit and in many cases to make refunds for overwithholding.

Dividends-received-credit approach. Another possible approach at the individual level would be to exempt dividends from a part of the individual income tax. Usually this approach contemplates exemption of dividends from the first bracket of the individual income tax, which would be equal to the corporate tax rate. But equality of the corporate rate and the individual first-bracket rate is not a necessary feature of the approach.

The dividends-received-credit aproach could eliminate "double taxation" in the literal sense by making sure that dividends never bore two taxes. But this approach could not eliminate relative overtaxation of distributed corporate profits. It could not approximate the partnership ideal so closely as the dividends-paid-credit approach or the withholding approach. The dividends-received-credit approach would grant no relief to stockholders not subject to the individual income tax. While these stockholders are not doubly taxed in the literal sense, they are overtaxed on dividends as compared with other kinds of income.

Nor would the dividends-received-credit approach equalize taxation of corporate profits and other kinds of income going to high-income stockholders. This approach would, in effect, consider the tax paid by the corporation as a payment on the tax liability of stockholders. But unlike the withholding approach, it would not require stockholders to include in their taxable income the tax paid on their behalf by the corporation. This would benefit high-income stockholders subject to high surtax rates more than low-income stockholders subject to low surtax rates. Although the dividends-received-credit approach could eliminate "double taxation" in the narrow sense and reduce the tax load on corporate profits, it could not so nearly equalize taxation of corporate profits and other kinds of income as could the dividends-paid-credit approach and the withholding approach.

It ought to be recognized that the dividends-received-credit approach would in effect introduce a new scale of graduated tax rates for distributed corporate profits. This new scale would start higher than the rate on other income but would end lower than the rate on other income. This may be a defensible rate scale, but its merits are not obvious; they would have to be established explicitly, in fair competition with the claims of other possible schedules.[1]

[1] If, as is usually suggested, the corporate tax rate and the individual first-bracket rate were equal, the *combined* corporate and individual taxes on distributed profits would be lower than the rate on other kinds of income for all stockholders subject to more than the first-bracket individual rate. In such cases, the combined taxes would be less than the individual tax alone that would

The dividends-received-credit approach could reduce, but not wholly eliminate, tax discrimination against equity financing and against the corporate form of doing business. This approach would be simple to administer.

Dividend-exclusion approach. Another approach would be to allow stockholders to exclude a part of dividends received from their taxable incomes. This approach would reduce taxes on corporate profits, but it could not equalize the taxation of corporate profits and other kinds of income. The tax value of the exclusion of dividends would equal the present relative overtaxation of dividend income only by coincidence and then only for one taxable income bracket. All other stockholders would get either a smaller or a larger benefit. Nontaxable stockholders would get no benefit at all.

It is clear that the tax value of the dividend exclusion would vary directly with the surtax rate applicable to the stockholder's dividend income. Thus, high-income stockholders would benefit substantially from the dividend-exclusion approach while low-income stockholders would benefit much less, or not at all. The allocation of tax reductions among different stockholders under the dividend-exclusion approach would not approximate the present overtaxation of distributed corporate profits as measured against the "ideal" standard of the partnership approach. Like the dividends-received-credit approach, the dividend-exclusion approach would in effect provide a new scale of graduated rates for distributed profits — a scale beginning relatively high and ending relatively low.

Conclusions

The problem of corporate tax reform is complicated by uncertainty as to the real effects of the present system, but the discussion has been enriched by the number of different plans suggested. Among the main approaches, only the partnership approach could completely equalize taxation of corporate profits and other kinds of income. But both the dividends-paid-credit approach and the withholding approach could equalize taxes on distributed profits and other income, while continuing a corporate tax on retained profits. The dividends-received-credit approach and the dividend-exclusion approach could reduce taxes on distributed profits but could not equalize taxes on this and other kinds of income.

While the problem of relative overtaxation of corporate profits is at the root of most criticisms against the corporate tax, the objective of equalizing taxes on corporate profits and other kinds of income is not the only factor to be considered in designing the postwar corporation tax structure. One controlling condition is revenue adequacy. Moreover, possible economic gains from remodeling the present structure can be appraised only by comparing the effects of the present corporate tax on consumption, investment, and national income with the effects of other taxes, which would have to be higher than would otherwise be necessary if the tax on corporate profits were lower.

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apply if there were no corporate tax and dividends were subject only to regular individual rates. Suppose, for example, the corporate tax and the first-bracket individual rate were both 20 per cent and that Stockholder A were subject to a 50 per cent individual rate, made up of the 20 per cent first-bracket rate and 30 per cent higher bracket rates. On $1.00 of profits a corporation would pay 20 cents in tax; on the remaining 80 cents of cash dividends, A would pay 24 cents in tax; the combined corporate and individual taxes would be 44 cents. Yet, if there had been no corporate tax, A would have paid 50 cents in the individual tax on $1.00 of dividend income.

LOWNDES, TAXING THE INCOME OF THE CLOSE CORPORATION *

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Although there is no substantial agreement about how the income from close corporations should be taxed, there appears to be virtual unanimity with respect to the defects of the present system.

The basic weakness of the method adopted by the federal income tax for taxing corporate income is that it is predicated upon a legal fiction which ignores economic realities. In the case of a partnership, the partnership is disregarded and the partners are taxed directly upon their distributive shares of the partnership income.[1] In the case of a corporation, however, the law gives full credence to the corporate fiction. Although in substance a close corporation represents an incorporated partnership, or perhaps an incorporated sole proprietorship, the corporate entity is treated as an independent taxable entity, and the income of the undertaking is taxed to the legal convention, rather than to the real owners of the enterprise.

The recognition of the corporation as a distinct taxable entity has several unhappy corollaries. Even in the case of the publicly owned corporation, it results in a complete disregard of the ability to pay principle, which is supposed to be one of the cardinal desiderata of an income tax. Although there is considerable speculation about the actual incidence of the corporate income tax, and whether the burden of the tax is shifted to the consumer in the form of higher prices, or to the corporate employees in the form of lower wages, or to the stockholders in the form of diminished dividends, it is clear that the actual burden of the tax is not imposed upon the corporation, which is a legal fiction. The corporate tax, which in recent years has been graduated according to the size of the corporate income, obviously bears no relation to the wealth or the ability to pay of the person who actually pays the tax, whoever he may be.

In the case of close corporations there are more fundamental objections to the current system of taxing corporate income. Some taxes are unjust because they bear too heavily upon a particular class of taxpayers. Others lack equity because they are susceptible to manipulation which makes it possible for the sophisticated taxpayer to shift his legitimate share of the tax burden to some more ingenuous citizen. The corporate tax enjoys the dubious distinction of erring in both directions. Since corporate income is taxed in the first instance to the corporate entity, when it is earned, and again to the stockholders, when it is distributed to them in the form of dividends, while the income of a partnership or a sole proprietorship is taxed but once to the partners or the sole proprietor, the corporate tax discriminates against incorporated partnerships and incorporated sole proprietorships. On the other hand, the recognition of an artificial legal convention as an independent taxable entity is a constant stimulus to tax manipulation and tax avoidance.

The theoretical objections to the present system of taxing the income of close

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[1] The first federal income taxes, passed during the Civil War, taxed the income of corporations in the same way, that is, they ignored the corporate entity and taxed the shareholders directly upon their distributive shares of the corporate income. This system was sustained in Collector v. Hubbard, 12 Wall. 1 (1870), although the Supreme Court later repudiated the *Hubbard* case in Eisner v. Macomber, 252 U.S. 189, at 217-219 (1920), declaring that "the stockholder's share in the accumulated profits of the company is capital, not income" (p. 219), and that he realizes no income upon which he may be taxed under the Sixteenth Amendment until the corporate profits are distributed to him in the form of dividends.

corporations are that it makes the conduct of a business subordinate to tax considerations and interposes an unwarranted impediment to freedom of choice of the form of business organization, because of the double tax on corporate income, as contrasted with the single tax upon the income of a partnership or a sole proprietorship. Moreover, by treating the corporate personality as a distinct taxable entity, the corporate tax serves as a shield behind which the tax dodger may conduct his maneuvers with impunity.

The ultimate test of a tax, however, lies in the practical operation of the tax in a concrete context, rather than its theoretical imperfections. The present system of taxing the income of close corporations must be judged by whether it really does create a genuine obstacle to conducting a business as a corporation rather than a partnership or sole proprietorship, and whether it actually encourages tax manipulation and tax avoidance.

Choice of Form of Business Organization: The Close Corporation Versus the Partnership or Sole Proprietorship

It is difficult to determine the precise extent to which the present system of taxing the income of close corporations constitutes a genuine impediment to the selection of the corporate form to conduct a business, which could be carried on as a partnership or sole proprietorship, because the relative tax advantages and disadvantages of various forms of business organization are linked so intimately with the concrete facts of a particular situation. In some cases it may actually be more economical to do business as a corporation. In others, a partnership or a sole proprietorship is preferable from a tax point of view. Unquestionably, the fact that the income of a close corporation is taxed differently than that of a partnership or a sole proprietorship is a predominating factor in the selection of the form of business organization. It is not, however, a consideration which inclines constantly in the same direction, since the tax advantages of one form of organization over another shift continually with changes in the underlying factual situation.

Because the tax advantages of a particular form of business organization are tied so closely to the unique facts of the particular situation, it is impossible to lay down any rigid rule which can be applied indiscriminately in every case to determine the most economical form of doing business from a tax point of view. It is feasible, however, to point out some of the major tax factors which must be weighed in choosing a form of business organization to illustrate the unwarranted predominance which tax considerations have achieved in this area, because of the identification of the corporation as an independent taxable entity.

A. Rates

A basic consideration in the choice of a corporation or a partnership or sole proprietorship as a form of business organization is the matter of rates, since corporate income is taxed under a different rate schedule than that applied to individual income, and corporate income is subject to the excess profits tax, which does not apply to other types of income.* There is, however, no constant ratio between the corporate tax and the individual tax, since this depends upon such variant factors as the size of the income, the application of the excess profits tax, and the personal status of the individual taxpayer. The recent revenue acts, which have reimposed the excess profits tax and permitted married taxpayers to

* An excess profits tax was in effect during World War II and during the period 1950-1953. — Ed.

split their incomes, have tended to favor partnerships and sole proprietorships, rather than corporations, as a form of business organization. However, the actual rate, at which the income from an enterprise is taxed, depends to such an extent upon the unique facts of the particular situation that it is impossible to generalize about which rates are more favorable.

B. Double Taxation

An important factor in determining the actual *effective* rate of tax upon the income of a close corporation is the possibility of avoiding a double tax. If corporate income is taxed first to the corporation, when it is earned, and again to the stockholders, when it is distributed to them in the form of dividends, it is obvious that the aggregate tax upon corporate income will be heavier than that which would be incurred by a partnership or a sole proprietorship.* In many cases, however, it is possible to eliminate the double tax. In a given situation it may even be possible to divide the income from an incorporated enterprise between the corporation and the individual entrepreneurs, so that part of the income is taxed to the corporation and part to the individual shareholders, with a lower aggregate tax than if it were all taxed directly to the individual owners of the business.

As a general rule, if the corporate profits can be distributed to the stockholders in a form which is deductible from the corporate income, a business may be conducted as a corporation about as economically from a tax point of view as a partnership, because of the elimination of any additional corporate tax. Thus, many small enterprises, whose earnings are derived chiefly from the efforts of the owners of the business, are able to operate as corporations without any undue tax penalty, because they can distribute their profits in the form of salaries, which are deductible from the corporate income. In fact, if part of the corporate earnings are plowed back into the business for expansion, it may be more economical to operate as a corporation than a partnership. In the case of a partnership, all of the partnership income is taxed to the partners, regardless of whether it is distributed to them or retained in the business. There is, therefore, no opportunity to divide the income from the business between the partners and the firm. In the case of a corporation, however, if part of the corporate income can be distributed to the shareholders in the form of salaries, or other items deductible from the corporate income, and part can be retained in the corporation, it is possible to divide the income from the enterprise between the corporation and the stockholders, so as to take advantage of the lower brackets under both the corporate and individual taxes.

Of course, matters may not work out so neatly. The deduction for salaries is limited to reasonable salaries, or in the words of the statute to "a reasonable allowance for salaries or other compensation for personal services actually rendered." Moreover, there are restrictions upon the earnings which a corporation may retain without encountering the surtax under [§531, infra p. 615], which is imposed as a penalty upon a corporation "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed." The limitation upon the deduction for salaries to reasonable salaries may create an awkward situation, if the particular stockholder needs a greater portion of the earnings of the business

* In 1954, Congress enacted a dividends-received exclusion and a credit to moderate the effect of the separate corporate tax; the exclusion was broadened, and the credit eliminated for future years, by the Revenue Act of 1964. See infra pages 604-606. — Ed.

than can properly be regarded as reasonable compensation for the services which he renders to the corporation. Furthermore, in order to accumulate earnings in the corporation without incurring the [§531] surtax, there must be some showing that they are needed for expansion or some independent business purpose of the corporation.

Salaries or compensation for personal services are not the only items which may be deducted from corporate income. Although dividends distributed by a corporation are not deductible in computing the corporate tax, the interest which a corporation pays on its debts is. Consequently, it has become customary to finance a corporation largely with borrowed capital in order to distribute the corporate earnings in the form of interest upon its obligations, which is deductible from the corporate income. . . . In addition to deducting the interest paid on the obligations of the corporation, it is possible to retain substantial amounts of the corporate earnings in the corporate treasury to fund its indebtedness without incurring the [§531] surtax. Moreover, the corporation can distribute its earnings by redeeming its bonds, or paying off its debts, without subjecting such payments to an additional tax in the hands of the stockholder-creditors, where a similar distribution in redemption of part of its stock would run the risk of being taxed as an ordinary dividend under [§302].

While thin incorporation has its advantages, there is a still unsettled problem as to just how thin incorporation can get before the Commissioner can see through it. It has been held that if the borrowed capital is substantially disproportionate to the equity capital, the borrowed capital will be treated as equity capital and a deduction for interest paid on the borrowed capital will be disallowed. Moreover there appears to be no manifest reason why the redemption of bonds in such a case could not be taxed under [§302] as an ordinary dividend. It is obvious that while it may be possible to eliminate a corporate tax by paying out corporate earnings in the form of interest rather than dividends, the restrictions on thin incorporations, like the limitation upon the deduction of salaries, make this a matter calling for skillful and sophisticated tax management.

In addition to the distribution of corporate earnings in the form of salaries and interest to minimize or eliminate the corporate income tax, part of the corporate profits are frequently paid out in the form of rent, which the corporation can deduct from its income as a business expense. Under this scheme, the stockholders will retain title to the property which the corporation needs to operate its business and lease it to the corporation, so that the rent paid by the corporation can be deducted from its income. Here again, however, caution must be exercised. If the rent paid by the corporation is in excess of the fair figure which would have been fixed in an arm's length transaction, the excess above the fair rental value of the property will be disallowed as a deduction. It seems possible, moreover, that if the lease simply represents a scheme for diverting income from the corporation and serves no independent business purpose of the corporation, any deduction for rent may be disallowed while the rent itself may be taxed to the stockholder who receives it as a dividend.*

C. Tax-Exempt Income; Capital Gains

In addition to the effective rates of tax upon the income of an enterprise conducted as a corporation and as a partnership, there are other differences between the ways in which corporations and partnerships are taxed, which follow as more or less logical corollaries from the recognition of the corporation as a distinct

* See White v. Fitzpatrick, supra page 406. — Ed.

taxable entity, and which must be taken into account in the choice of a form of business organization. One of these differences, for example, is the way in which tax-exempt income of a corporation and of a partnership is treated.

Tax-exempt income of a partnership does not lose its tax-exempt status when it is taxed to the partners, since the partnership is merely a conduit for allocating the partnership income to the partners. Tax-exempt income of a corporation, however, is transmuted into taxable income when it passes through the hands of the corporation and is distributed in the form of dividends, since the exemption is lost by the interposition of an independent taxable entity between the income and the stockholders. The moral, of course, is plain. Tax-exempt or partially tax-exempt income should not be given to a corporation, but should, as far as practicable, be retained by the individual stockholders.

The fact that income may change its character between the time it is earned by a corporation and distributed to the stockholders does not, however, always work to the disadvantage of the stockholders. It is sometimes possible to convert ordinary income of a corporation into a long-term capital gain in the hands of a stockholder by liquidating the corporation. Incidentally, however, there is no profit in transferring capital assets, which have increased in value, to a corporation with the idea of having the corporation sell the assets and realize the gain, since the minimum tax which a corporation must pay upon such a gain is [25] per cent, which is the maximum tax which an individual may pay, and he may pay less. Moreover, if the gain realized by the corporation is ultimately distributed to the stockholder it will be taxed to him again, and, unless the distribution occurs in connection with a liquidation of the corporation, taxed as ordinary income.

D. Deferring Gains and Losses

One of the advantages of conducting an expanding business as a corporation, which was noted earlier, is that the earnings which are retained by the corporation may be kept out of the incomes of the stockholders and taxed to the corporation in a lower bracket than they would be taxed to the stockholders. In other words, this is a possible way of dividing the income of a business between the corporation and the proprietors of the business and taking advantage of the lower brackets of both the corporate and individual taxes. On the other hand, if a business is conducted as a partnership or a sole proprietorship, all of the income of the business will be taxed to the partners or to the sole proprietor, regardless of whether it is actually distributed to them or plowed back into the business.

Conversely, however, it may be advantageous to organize a new business, in which losses are anticipated in the early years, as a partnership or sole proprietorship, rather than a corporation, since the losses incurred in starting the business can be utilized directly by the partners or the sole proprietor to offset their gains from other sources, and if they arise from the operation of the business, as distinguished from the sale or exchange of capital assets, they will be fully deductible as ordinary business losses. If, on the other hand, the business is conducted as a corporation, any losses incurred in the operation of the business will be the losses of the corporation and cannot be availed of by the stockholders. Although such losses may give rise to a net operating loss which can be carried over and offset against the profits of later years, if the corporation continues to be unsuccessful and realizes no gains the carry-over cannot be utilized either by the corporation or the stockholders. Moreover, although the stockholders will realize a loss when the corporation is finally liquidated, the loss will ordinarily take the form of a long-term capital loss subject to the restrictions on such losses.

E. Organization and Liquidation

Although theoretically a corporation should pay a heavier tax than a partnership or a sole proprietorship, because corporate income is exposed to the hazard of a double tax, actually the tax burden of a close corporation depends upon a number of adventitious circumstances. Moreover, the circumstances which determine the relative tax advantages of doing business under the corporate form are not static but are subject to constant fluctuation. At one stage in the existence of a business, it may be profitable to operate as a corporation, and at another, as a partnership or sole proprietorship. Not only changes in the fortunes of the business, but changes in the law, such as the enactment or repeal of an excess profits tax, permission for married taxpayers to split their incomes, and upward and downward revisions in the corporate and individual rate schedules, may make a change in the form of business organization imperative. In this connection it is important to bear in mind that it is much easier to shift into a corporation than it is to shift out of one.

A partnership can be organized or liquidated without realizing taxable gain or loss. Moreover, a partnership can be converted into a corporation without incurring any gain or loss, if the partners are in control of the corporation after the transfer of the partnership assets to the corporation, and they retain the same proportionate interests in the corporation, which they had in the partnership property.

The recognition of the corporation as a distinct taxable entity, however, usually makes it impossible to liquidate a corporation and shift to a partnership without serious tax consequences.

NOTE

1. *Dividends received exclusion and credit.* The most controversial part of the 1954 Code was its approach to the "double taxation" of corporate earnings: §116 and §34 permitted the individual taxpayer to exclude from gross income $50 of dividends per year and to take a credit against his tax liability equal to 4 per cent of the balance of his dividends. Thus, a taxpayer receiving $550 of dividends was required to include $500 in gross income, and he was allowed a credit of $20 against his tax liability.

President Kennedy's Tax Message of April 20, 1961, recommended repeal of both the exclusion and the credit. In support of this proposal, Secretary Dillon said in his statement to the House Ways and Means Committee:

> Whether there is, in fact, double taxation of dividends has been the subject of much controversy. However, even assuming the existence of such double taxation the fact remains that the dividend credit and exclusion give a considerably larger relative reduction in the burden of double taxation to the dividend recipient with high income than to the dividend recipient with low income.
>
> This point may be made clear by considering the average stockholder in a particular income class. The corporate tax [at the pre-1964 rate] imposes an extra tax burden, over and above the personal tax on dividends, of 52 cents per dollar of corporate profit before tax for shareholders not liable to income tax, 42 cents per dollar of corporate profits before tax for stockholders in the 20-percent tax bracket (for example, married couples with less than $5,000 income), and of but 5 cents per dollar of corporate profits on those with incomes of over $1 million. On the average, the credit and exclusion combined reduce this extra burden by 3 cents per dollar of corporate profit before tax for married couples with income of $5,000, and by 2 cents for those with income over $1 million. The percentage reduction of the so-called double tax is thus only 8 percent for low income stockholders, while it is 41 percent

for high income stockholders. This deficiency of the credit and exclusion has been noted widely. Surely a technique as discriminatory as this has little to recommend it.

The dividend credit represents a dead-end approach toward the equitable taxation of dividends. In 1954 the provisions were represented as only a first step toward full relief, which was eventually to be achieved by raising the credit to 15 percent of dividends. However, it is not possible to increase the credit to such a level without giving those in the high tax brackets reductions exceeding the extra burdens they are presumed to bear as a result of the corporate income tax. For example, the tax relief granted by a 15-percent credit would amount to 7.2 cents per dollar of corporate earnings before tax — or about 25 percent more than the extra burden presumed to fall on those with incomes of $250,000 because of the corporate tax. With a 20-percent credit, which has been recommended by some, the tax relief at high income brackets could be twice as large as the presumed extra burden of the corporate tax.

Looked at as straight tax reduction, the benefits provided by these provisions are highly concentrated in the upper income groups. In recent years less than 9 percent of the total combined tax reductions from the dividend credit and exclusion have gone to returns with less than $5,000 of income. In contrast, more than 75 percent of the total tax reductions accrue to returns with incomes of $10,000 and over and more than 54 percent to taxpayers with incomes over $20,000. In view of the fact that the dividend exclusion is frequently represented as being helpful to low-income groups, it is noteworthy that only about 15 percent of the total tax reduction due to such exclusions go to returns with incomes under $5,000. About 55 percent of its tax benefits go to individuals with over $10,000 of income.

Benefits from the 1954 dividend provisions accrue more broadly at the higher income levels because shareholding is more usual at those levels. Only 6 per cent of taxable returns with income under $5,000 have any dividends at all, while over 90 percent of returns with incomes of over $50,000 have dividends. Dividend income for returns under $5,000 constitutes but 1 percent of total income of this group as against 29 percent for the higher group. Putting it differently, returns with incomes under $5,000, or 40 percent of the total number of taxable returns, report only about 8 percent of the dividends included in tax returns. On the other hand, returns with incomes over $50,000, or two-tenths of 1 percent of all returns, account for 33 percent of all dividends. Any way one looks at it, the overall benefit of the dividend credit is much larger for the upper income groups.

Secretary Dillon also argued that the credit and exclusion had not significantly contributed to a dispersion of stock ownership in the years since 1954.

In his 1963 Tax Message, President Kennedy repeated this recommendation for repeal of the credit and exclusion, adding that its enactment was essential to his support for a reduction of the top individual tax rate to 65 per cent.

As enacted, the 1964 Revenue Act increased the exclusion from $50 to $100, reduced the credit to 2 per cent for 1964, and eliminated the credit for dividends received in 1965 and later years. If they file a joint return, a married couple may exclude $200 of dividends, provided each of them receives $100 or more of dividend income. In keeping with the "double taxation" rationale for the exclusion and credit, they do not apply to dividends paid by foreign corporations or by certain other corporations whose earnings are not subject to the corporate income tax.

The Republican members of the House Ways and Means Committee criticized the 1964 amendments as follows:

In 1954 Congress recognized the tax incident in regard to the three methods of corporate financing which was unequal with regard to new equity financing and resulted in a penalty exacted of corporate stockholders by taxing their corporate earnings at the rate of 52 percent and then taxing again the same income when distributed as dividends to individuals. As a partial alleviation of this inequity the Congress exempted the first $50 of dividends received by an individual and allowed a tax credit of 4 percent for any dividend income in excess of the $50 exclusion.

Initially, the Kennedy administration recommended that the $50 exclusion and the 4-percent credit for dividends be repealed. It was claimed that the reduction of cor-

porate taxes would alleviate the problem of double taxation. The committee rejected this proposal by a substantial majority. Subsequently, a "compromise" was offered whereby the 4-percent credit would be repealed, but the $50 exclusion would be raised to $100. After several efforts failed, the administration exerted sufficient pressure on the committee to bring about the approval of this "compromise" by a slim margin of one vote. How was this justified?

An unidentified labor economist put his finger on the crux of the matter. The 4-percent dividend credit was termed "class legislation." As this economist said, the repeal of this provision would affect less than 6 percent of American families. Even if this is correct, it does not make double taxation of investment earnings any more equitable. The repeal of this provision epitomizes the demagogic approach which has been resorted to time and time again by the majority.

The repeal of the tax credit on dividends is not only inequitable, but shortsighted. The Kennedy administration has constantly bemoaned the rate of economic growth, and exaggerated the unemployment problem. Tax proposals, trade bills, and other gimmicks have been foisted upon the Congress as economic stimulants to produce full employment. On the other hand, this bill sets about to take away one of the most justifiable stimulants to business investment. Equity capital is needed to create jobs. Yet, by the repeal of the 4-percent credit the tax on equity capital is made more burdensome.

The effect of making equity financing more burdensome will be to force the more heavy reliance on borrowing and retained earnings. The tax laws already impose a much lesser burden on the fruits of borrowed capital and retained earnings than on the fruits of equity capital. This has created a narrow equity base, which is more vulnerable to economic fluctuations. Stock prices are inflated because of imbalance between supply and demand. Industry is burdened with fixed interest charges on borrowed capital, rather than with the flexible dividend cost of maintaining high equity capital. A tax bill which is designed to expand the economy should provide greater, not lesser, incentives for equity capital. [H.R. Rept. No. 749, 88th Cong., 1st Sess. c25-c26.]

The 1954-1964 battles, it should be noted, were concerned with dividends received by individuals, not with those received by corporations. For many years, the Code has made special allowance for intra-corporate dividends; since 1954, the allowance has taken the form of a special deduction equal to 85 per cent of dividends received, so that in effect only 15 per cent of a corporation's dividend income is subjected to tax. See §243. In addition, an affiliated group of corporations (supra p. 417) can eliminate intra-group dividends from gross income entirely by electing to file consolidated returns. Moreover, under a 1964 amendment, members of an affiliated group may deduct 100 per cent (rather than 85 per cent) of intra-group dividends — without filing consolidated returns — if they make an election under §214. As a condition of this election, however, only one $25,000 surtax exemption and one $100,000 minimum accumulated earnings credit is allowed to the group as a whole, rather than one to each corporation.

2. *Corporate elections under Subchapter S.* Subchapter S (§§1371-1377), enacted in 1958, permits an election by certain closely held corporations, provided all of the shareholders consent, under which the corporation will not be subject to the corporate income tax and its income will be taxed directly to the shareholders, whether distributed to them or accumulated by the corporation. The availability of this election alters, in certain respects, some of the comparisons and strategies suggested in the foregoing materials. Subchapter S is examined infra pages 740 et seq.

3. *Unincorporated enterprises electing to be taxed as corporations.* Sometimes a business enterprise is carried on in partnership form or as a proprietorship for local law reasons, but the investors would like it to be taxed as a corporation. For this possibility, see page 612 infra.

4. *References.* The double taxation of corporate dividends is discussed by various authorities in 1959 Tax Revision Compendium 1537-1609 (House Ways and Means Committee); see also Goode, The Corporation Income Tax (1951); Somers, The Place of the Corporation Income Tax in the Tax Structure, 5 Nat. Tax J. 279 (1952); Slitor, The

Corporation Income Tax: A Re-Evaluation, id. at 289; Groves, Postwar Taxation and Economic Progress 20-73 (1946); Holland, Dividends Under the Income Tax (1962).

For a comparison of the various forms of business enterprise, from the point of view of the practicing lawyer, see Knapp, Forms of Business Organization and the Federal Income Tax Laws (P.L.I. 1957).

SECTION B. THE CORPORATION AS A TAXABLE ENTITY

Section 7701(a)(3) of the 1954 Code, defining the term "corporation" to include "associations," is identical with §3797(a)(3) of the 1939 Code.

MORRISSEY v. COMMISSIONER

296 U.S. 344 (1935)

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

Petitioners, the trustees of an express trust, contest income taxes for the years 1924 to 1926, inclusive, upon the ground that the trust has been illegally treated as an "association." . . . We granted certiorari because of a conflict of decisions as to the distinction between an "association" and a "pure trust," the decisions being described in one of the cases as "seemingly in a hopeless state of confusion." Coleman-Gilbert Associates v. Commissioner, 76 F.(2d) 191, 193.

The facts were stipulated. In the year 1921 petitioners made a declaration of trust of real estate in Los Angeles. They were to be designated in "their collective capacity" as "Western Avenue Golf Club." The trustees were authorized to add to their number and to choose their successors; to purchase, encumber, sell, lease and operate the "described or other lands"; to construct and operate golf courses, club houses, etc.; to receive the rents, profits and income; to make loans and investments; to make regulations; and generally to manage the trust estate as if the trustees were its absolute owners. The trustees were declared to be without power to bind the beneficiaries personally by "any act, neglect or default," and the beneficiaries and all persons dealing with the trustees were required to look for payment or indemnity to the trust property. The beneficial interests were to be evidenced solely by transferable certificates for shares which were divided into 2,000 preferred shares of the par value of $100 each, and 2,000 common shares of no par value, and the rights of the respective shareholders in the surplus, profits, and capital assets were defined. "Share ledgers" showing the names and addresses of shareholders were to be kept.

The trustees might convene the shareholders in meeting for the purpose of making reports or considering recommendations, but the votes of the shareholders were to be advisory only. The death of a trustee or of a beneficiary was not to end the trust, which was to continue for twenty-five years unless sooner terminated by the trustees.

During the years 1921 and 1922, the trustees sold beneficial interests and paid commissions on the sales. About 42 acres (of the 155 acres described by the declaration of trust) were plotted into lots which were sold during the years 1921 to 1923, most of the sales being on the installment basis. On the remaining property a golf course and club house were constructed, and in 1923 this property with the improvements was conveyed to Western Avenue Golf Club, Inc., a California corporation, in exchange for its stock. Under a lease from the corporation, petitioners continued the operation of the golf course until January 12, 1924. After that date petitioners' activities were confined to collections of installments of principal and interest on contracts of purchase, the receipt of interest on bank

balances and of fees on assignments by holders of purchase contracts, the execution of conveyances to purchasers, the receipt of dividends from the incorporated club, and the distribution of moneys to the holders of beneficial interests. On December 31, 1923, the total number of outstanding beneficial interests was 3016, held by 920 persons; by December 31, 1926, the number of interests had been gradually decreased to 2172, held by 275 persons. The holdings by the trustees ranged approximately from 16 to 29 per cent.

Petitioners contend that they are trustees "of property held in trust," within [§641(a)], and are taxable accordingly and not as an "association." They urge that, to constitute an association, the applicable test requires "a quasi-corporate organization in which the beneficiaries, whether or not certificate holders, have some voice in the management and some control over the trustees and have an opportunity to exercise such control through the right to vote at meetings"; and that, in any event, the activities in which petitioners were engaged, during the tax years under consideration, did not constitute "a carrying on of business" within the rule applied by this Court.

The Government insists that the distinction between associations and the trusts taxed under [§641(a)] is between "business trusts on the one side" and other trusts "which are engaged merely in collecting the income and conserving the property against the day when it is to be distributed to the beneficiaries"; that Congress intended that all "business trusts" should be taxed as associations.

[Section 7701(a)(3) provides:]

"The term 'corporation' includes associations, joint-stock companies, and insurance companies." . . .

"Association" implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, an enterprise for the transaction of business. This is not the characteristic of an ordinary trust — whether created by will, deed, or declaration — by which particular property is conveyed to a trustee or is to be held by the settlor, on specified trusts, for the benefit of named or described persons. Such beneficiaries do not ordinarily, and as mere cestuis que trust, plan a common effort or enter into a combination for the conduct of a business enterprise. Undoubtedly the terms of an association may make the taking or acquiring of shares of interests sufficient to constitute participation, and may leave the management, or even control of the enterprise, to designated persons. But the nature and purpose of the cooperative undertaking will differentiate it from an ordinary trust. In what are called "business trusts" the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains. Thus a trust may be created as a convenient method by which persons become associated for dealings in real estate, the development of tracts of land, the construction of improvements, and the purchase, management and sale of properties; or for dealings in securities or other personal property; or for the production, or manufacture, and sale of commodities; or for commerce, or other sorts of business; where those who become beneficially interested, either by joining in the plan at the outset, or by later participation according to the terms of the arrangement, seek to share the advantages of a union of their interests in the common enterprise.

The Government contends that such an organized community of effort for the doing of business presents the essential features of an association. Petitioners stress the significance of, and the limitations said to be implied in, the provision classifying associations with corporations.

The inclusion of associations with corporations implies resemblance; but it is resemblance and not identity. The resemblance points to features distinguishing

associations from partnerships as well as from ordinary trusts. As we have seen, the classification cannot be said to require organization under a statute, or with statutory privileges. The term embraces associations as they may exist at common law. Hecht v. Malley, 265 U.S. 144 (1924). We have already referred to the definitions, quoted in that case, showing the ordinary meaning of the term as applicable to a body of persons united without a charter "but upon the methods and forms used by incorporated bodies for the prosecution of some common enterprise." These definitions, while helpful, are not to be pressed so far as to make mere formal procedure a controlling test. The provision itself negatives such a construction. Thus unincorporated joint-stock companies have generally been regarded as bearing the closest resemblance to corporations. But, in the revenue acts, associations are mentioned separately and are not to be treated as limited to "joint-stock companies," although belonging to the same group. While the use of corporate forms may furnish persuasive evidence of the existence of an association, the absence of particular forms, or of the usual terminology of corporations, cannot be regarded as decisive. Thus an association may not have "directors" or "officers," but the "trustees" may function "in much the same manner as the directors in a corporation" for the purpose of carrying on the enterprise. The regulatory provisions of the trust instrument may take the place of "by-laws." And as there may be, under the reasoning in the *Hecht* case, an absence of control by beneficiaries such as is commonly exercised by stockholders in a business corporation, it cannot be considered to be essential to the existence of an association that those beneficially interested should hold meetings or elect their representatives. Again, while the faculty of transferring the interests of members without affecting the continuity of the enterprise may be deemed to be characteristic, the test of an association is not to be found in the mere formal evidence of interests or in a particular method of transfer.

What, then, are the salient features of a trust — when created and maintained as a medium for the carrying on of a business enterprise and sharing its gains — which may be regarded as making it analogous to a corporate organization? A corporation, as an entity, holds the title to the property embarked in the corporate undertaking. Trustees, as a continuing body with provision for succession, may afford a corresponding advantage during the existence of the trust. Corporate organization furnishes the opportunity for a centralized management through representatives of the members of the corporation. The designation of trustees, who are charged with the conduct of an enterprise — who act "in much the same manner as directors" — may provide a similar scheme, with corresponding effectiveness. Whether the trustees are named in the trust instrument with power to select successors, so as to constitute a self-perpetuating body, or are selected by, or with the advice of, those beneficially interested in the undertaking, centralization of management analogous to that of corporate activities may be achieved. An enterprise carried on by means of a trust may be secure from termination or interruption by the death of owners of beneficial interests and in this respect their interests are distinguished from those of partners and are akin to the interests of members of a corporation. And the trust type of organization facilitates, as does corporate organization, the transfer of beneficial interests without affecting the continuity of the enterprise, and also the introduction of large numbers of participants. The trust method also permits the limitation of the personal liability of participants to the property embarked in the undertaking.

It is no answer to say that these advantages flow from the very nature of trusts. For the question has arisen because of the use and adaptation of the trust mechanism. The suggestion ignores the postulate that we are considering those trusts which have the distinctive feature of being created to enable the participants to

carry on a business and divide the gains which accrue from their common undertaking, — trusts that thus satisfy the primary conception of association and have the attributes to which we have referred, distinguishing them from partnerships. In such a case, we think that these attributes make the trust sufficiently analogous to corporate organization to justify the conclusion that Congress intended that the income of the enterprise should be taxed in the same manner as that of corporations.

Applying these principles to the instant case, we are of the opinion that the trust constituted an association. The trust was created for the development of a tract of land through the construction and operation of golf courses, club houses, *etc.* and the conduct of incidental businesses, with broad powers for the purchase, operation and sale of properties. Provision was made for the issue of shares of beneficial interests, with described rights and priorities. There were to be preferred shares of the value of $100 each and common shares of no par value. Thus those who took beneficial interests became shareholders in the common undertaking to be conducted for their profit according to the terms of the arrangement. They were not the less associated in that undertaking because the arrangement vested the management and control in the trustees. And the contemplated development of the tract of land held at the outset, even if other properties were not acquired, involved what was essentially a business enterprise. The arrangement provided for centralized control, continuity, and limited liability, and the analogy to corporate organization was carried still further by the provision for the issue of transferable certificates.

Under the trust, a considerable portion of the property was surveyed and subdivided into lots, which were sold and, to facilitate the sales, the subdivided property was improved by the construction of streets, sidewalks, and curbs. The fact that these sales were made before the beginning of the tax years here in question, and that the remaining property was conveyed to a corporation in exchange for its stock, did not alter the character of the organization. Its character was determined by the terms of the trust instrument. It was not a liquidating trust; it was still an organization for profit, and the profits were still coming in. The powers conferred on the trustees continued and could be exercised for such activities as the instrument authorized. . . .

The judgment is affirmed.

NOTE

1. *The 1954 "association" Regulations.* The "association" Regulations under the 1954 Code, Regs. §301.7701-2, are much more detailed than their pre-1954 counterpart, although there was no change in the applicable statute. The 1954 Regulations provide that the major characteristics of a "pure corporation" are (a) associates, (b) an objective to carry on business and divide the gains therefrom, (c) continuity of life, (d) centralization of management, (e) limited liability, and (f) free transferability of interests. They then go on to provide:

> (2) Since associates and an objective to carry on business for joint profit are essential characteristics of all organizations engaged in business for profit (other than the so-called one-man corporation and the sole proprietorship), the absence of either of these essential characteristics will cause an arrangement among co-owners of property for the development of such property for the separate profit of each not to be classified as an association. Some of the major characteristics of a corporation are common to trusts and corporations, and others are common to partnerships and corporations. Characteristics common to trusts and corporations are not material in attempting to distinguish between a trust and an association, and characteristics common to partnerships and corporations are not material in attempting to distinguish between an

association and a partnership. For example, since centralization of management, continuity of life, free transferability of interests, and limited liability are generally common to trusts and corporations, the determination of whether a trust which has such characteristics is to be treated for tax purposes as a trust or as an association depends on whether there are associates and an objective to carry on business and divide the gains therefrom. On the other hand, since associates and an objective to carry on business and divide the gains therefrom are generally common to both corporations and partnerships, the determination of whether an organization which has such characteristics is to be treated for tax purposes as a partnership or as an association depends on whether there exists centralization of management, continuity of life, free transferability of interests, and limited liability.

(3) An unincorporated organization shall not be classified as an association unless such organization has more corporate characteristics than noncorporate characteristics. In determining whether an organization has more corporate characteristics than noncorporate characteristics, all characteristics common to both types of organizations shall not be considered. For example, if a limited partnership has centralized management and free transferability of interests but lacks continuity of life and limited liability, and if the limited partnership has no other characteristics which are significant in determining its classification, such limited partnership is not classified as an association. Although the limited partnership also has associates and an objective to carry on business and divide the gains thereform, these characteristics are not considered because they are common to both corporations and partnerships. [Regs. §301.7701-2(a).]

See Zarky, Unincorporated Organizations Taxable as Corporations, 1961 So. Calif. Tax Inst. 277; Lyons, Comments on the New Regulations on Associations, 16 Tax L. Rev. 441 (1961); Sarner, Associations Taxable as Corporations: A Review and a Look Ahead, 20 N.Y.U. Inst. on Fed. Taxation 609 (1962).

2. *Professional associations and corporate status.* Although most of the "association" litigation concerns unincorporated entities that wish to avoid corporate status under the Internal Revenue Code, occasionally the shoe is on the other foot. See United States v. Kintner, 216 F.2d 418 (9th Cir. 1954), involving a group of physicians who wished to participate in a qualified pension plan; they could not do so if they practiced as partners, since §401 requires the plan to be "for the exclusive benefit of . . . employees," and they could not become employees of a corporation because the state law does not permit a corporation to practice medicine. An "association" gave them the status of a corporation for federal income tax purposes, without running afoul of state restrictions on the practice of medicine. In addition to pensions, the employees of an "association" may qualify for excludable sick pay under §105(d), employees' death benefits under §101(b), and other tax advantages that are denied to self-employed persons and partners.

There may be more than one way to skin a cat. A number of states have recently enacted legislation to permit attorneys, physicians, and other professionals to organize groups — sometimes called "corporations," sometimes "associations" — for the practice of their profession. The Connecticut statute (P.A. 158, §44), which is a rider to the Uniform Partnership Act rather than part of the corporation laws, provides in part:

> Notwithstanding the foregoing provisions of this Act, any three or more persons, licensed or authorized to practice a profession by the State of Connecticut, may associate to practice such profession for profit, if the articles of association of the members provide that the association thereby formed and hereby authorized shall have at least three of the following four attributes: (a) Continuity of life so that the death, insanity, bankruptcy, retirement, resignation, or expulsion of any member will not cause a dissolution of the association; (b) centralized management so that any one or more but less than all of the members has continuing exclusive authority to make management decisions necessary to the conduct of the professional business for which the association was formed, and so that no member of the association, acting without the authority of the managing member or members, shall have the power to bind the association by his act; (c) limited liability so that the individual members of the asso-

ciation shall not be individually or severally liable for its debts; provided, however, the members shall in no way limit their individual or several liability in the articles of association, or otherwise, for any acts of reckless or wanton misconduct, negligence, malpractice, professional misconduct, or tort; and (d) free transferability of interests so that each of its members or those members owing substantially all of the interests in the association have the power, without the consent of other members, to substitute for themselves in the same association a person duly licensed or authorized to practice the profession for which the association was formed who is not a member of the association, or, a modified form of free transferability of interests so that each member of the association can transfer his interests to a person so licensed or authorized who is not a member of the association only after having offered such interest to the association or to the other members of the association at its fair market value as established in the articles of association, or otherwise.

At the end of 1963, the Internal Revenue Service issued proposed Regulations under which these new-style professional groups would find it almost impossible to qualify as "associations" and hence as corporations. 28 Fed. Reg. 13,750 (Dec. 17, 1963). As proposed, the new Regulations eliminate an example in the 1954 Regulations which endorsed the result in the *Kintner* case, supra.

See Bittker, Professional Associations and Federal Income Taxation: Some Questions and Comments, 17 Tax L. Rev. 1 (1961); Ohl, Corporate Practice of Law in New York, 40 Taxes 263 (1962); Note, Professional Corporations and Associations, 75 Harv. L. Rev. 776 (1962); Snyder and Weckstein, Quasi-Corporations, Quasi-Employees, and Quasi-Tax Relief for Professional Persons, 48 Cornell L.Q. 613, 634-709 (1963); Grayck, Professional Associations and the Kintner Regulations: Some Answers, More Questions, and Further Comments, 17 Tax L. Rev. 469 (1962); Anderson, Tax Aspects of Professional Corporations, 1963 So. Calif. Tax Inst. 309.

Since the major reason for "professional corporation" laws is to enable self-employed attorneys, physicians, etc. to establish qualified pension and profit-sharing plans for themselves, pressure for the enactment and use of this type of legislation may be somewhat reduced by the enactment in 1962 of the Self-Employed Individuals Tax Retirement Act, which grants various tax concessions to such plans even though the beneficiaries are not "employees" of another person or entity. Despite the new legislation, however, there are advantages in participating as an "employee" in an old-style pension or profit-sharing plan. See Whiteside, Self-Employed Individuals Retirement Act of 1962, 51 Ky. L.J. 325 (1962); Snyder and Weckstein, supra.

3. *Unincorporated enterprises electing to be taxed as corporations.* In 1954, Congress enacted §1361, permitting certain unincorporated business enterprises (both partnerships and individual proprietorships) to elect to be taxed as corporations. An enterprise will not qualify if it is owned by more than fifty persons, and it is necessary that capital be a "material income producing factor" or that 50 per cent or more of gross income be derived from trading as a principal or acting as a broker in sales of real property, commodities, or securities. Ordinarily, of course, any enterprise that wishes to be taxed as a corporation can achieve its aim easily enough, by organizing in corporate form. Lawyers, doctors, and other professionals who are not permitted to practice in corporate form will not be able to take advantage of §1361, however, because they will be unable to meet the capital or gross income requirements. But individuals and partnerships that do not wish to limit their personal liability and can meet the requirements of §1361 may now continue to do business in unincorporated form while being taxed as corporations.

The provision "apparently received its main impetus and perhaps the only reason for its existence from the situation of a particular Georgia partnership," according to Surrey, The Congress and the Tax Lobbyist — How Special Tax Provisions Get Enacted, 70 Harv. L. Rev. 1145, 1149n (1957). It raises many technical problems, see Brown, Unincorporated Business Enterprises Electing to Be Taxed as Domestic Corporations — Section 1361, 1955 So. Calif. Tax Inst. 281; Wein's Estate v. Commissioner, 40 T.C. 454 (1963), aff'd per curiam, 330 F.2d 957 (3d Cir. 1964) (on incorporation of proprietorship that had elected under §1361, election is terminated; and under §1361(1), transaction must be treated as a complete liquidation requiring recognition of gain or loss); Borin v. United States, 322 F.2d 685 (5th Cir. 1963) (§1361 election valid though made after death of

proprietor); Sperapani v. Commissioner, 42 T.C. No. 18 (1964) (capital as a material income-producing factor).

Regulations under §1361 were not issued until 1960. As of 1959-1960, only 445 enterprises had elected to be taxed under §1361. Statistics of Income, Corporation Income Tax Returns, 1959-1960, pp. 7-8.

PAYMER v. COMMISSIONER

150 F.2d 334 (2d Cir. 1945)

Before L. HAND, SWAN, and CHASE, Circuit Judges.

CHASE, Circuit Judge.

These four petitions, which were consolidated for hearing, require us to decide whether the 1938 net income of certain real estate was taxable to the petitioning corporations each of whom held the title to a part of it, or to the petitioning individuals who owned all the stock of the two corporations. And, if the corporations are taxable on the income, whether their failure to file income and excess profits returns made them liable for a penalty. The Commissioner determined that the corporations were taxable and also that the individuals, to whom the income was paid directly by the lessees of the property, were taxable on the amounts each received on the theory that what was done was the equivalent of dividend distributions by the corporations. He also assessed a penalty against each corporation. The Tax Court affirmed.

The individual petitioners are two brothers, who have been in partnership for many years under the name of Paymer Bros., owning partnership property which has in part been real estate that they improved and managed. Because Samuel had become the co-signer on a note and the guarantor of an account both of which were overdue in 1932, it was then thought that he might be sued by creditors and the partnership property attached. To avoid that, if possible, the partners in that year organized Raymep Realty Corp., Inc. and Westrich Realty Corp., two New York corporations which were given broad powers to own, manage and dispose of real estate and conveyed to each of them a parcel of income-producing real estate in New York City. The conveyance to Raymep was in 1932 and was made directly by the partners. That to Westrich was conveyed first by the partners to Paymer Bros. Realty Corp. Inc., a corporation wholly owned by them, and was then by it deeded to Westrich. In each instance, each of the two partners received half of the stock of the grantee in exchange for the property. The minutes of a meeting of directors and stockholders of each grantee held about the time the property was deeded to it contain the following statement:

> The said conveyance was and is made with the express understanding that the corporation is only to hold title to the property, the beneficial interest and profits to be in the individual stockholders and the management and control of the property to be exclusively theirs. It is understood and agreed that this corporation was only organized for the convenience of the shareholders in the management thereof.

After these meetings neither corporate petitioner held any others. Neither ever elected any officers or directors after Samuel was elected president and Joseph treasurer at the organization meeting, ever had any office or bank account, or collected any income. The two partners managed the real estate conveyed as above and collected the income, paid the expenses, deposited the money received in the bank account of Paymer Bros., and used the net profits of the real estate as they pleased, treating that property as the partnership property it had formerly been. The leases existing on the real estate when the conveyances were made were not assigned to the corporations and nothing was done by Westrich in respect to the property held in its name. That is not true, however, as to Raymep for a loan

of $50,000 was obtained by it in 1938 and as part security for the loan it assigned to the lender all the lessor's rights, profits and interest in two leases on the property and covenanted that they were in full force and effect and that it was the sole lessor. Capital stock tax returns were filed by both Raymep and Westrich for the fiscal year ended June 30, 1938. During 1938 the two partners received gross rentals amounting to $18,999.86 from the property to which Raymep held the title and $3300 from that whose title was held by Westrich.

The petitioners, acting on the advice of their accountant, included the 1938 income from the property held by these corporations in their own partnership information return for that year, in which they also included the incomes and expenses of two other corporations wholly owned by them. The net income so reported was treated as the net income of the partners in their returns.

The petitioners now contend that Raymep and Westrich were mere "dummies" which held the legal title to property owned by the two individual petitioners and that both corporations are to be disregarded for income tax purposes. As a general rule a corporation is a taxpayer separate and distinct from its stockholders. New Colonial Ice Co. v. Helvering, 292 U.S. 435, 442. And this applies to a corporation wholly owned by one stockholder. Burnet v. Commonwealth Improvement Co., 287 U.S. 415. But there are exceptions and the corporate form will be disregarded where it serves no business purpose and is but a sham. Gregory v. Helvering, 293 U.S. 465. So, too, a taxpayer may gain the advantage of doing his own business through a wholly owned corporation if he pleases, but the treasury may disregard the separate corporate entity where it serves but as a shield against taxation and treat the one who actually may take the benefit of the income as the owner of the property which produces it and tax him accordingly. Higgins v. Smith, 308 U.S. 473. Yet the treasury may treat a corporation as a separate taxable entity when its organization "is followed by the carrying on of business by the corporation." Moline Properties v. Commissioner, 319 U.S. 436, 439.

We think that Raymep was active enough to justify holding that it did engage in business in 1938. The absence of books, records and offices and the failure to hold corporate meetings are not decisive on that question. Though Raymep was organized solely to deter creditors of one of the partners, it apparently was impossible or impracticable to use it solely for that purpose when it became necessary or desirable to secure the above mentioned loan in a substantial amount. There was, to be sure, less business activity than was shown in Sheldon Building Corporation v. Commissioner, 7 Cir., 118 F.2d 835, but we think enough did appear to make the principles applied in that case applicable to Raymep and that the decision of the Tax Court should be affirmed as to the taxability of that corporation. . . .

Westrich, however, was at all times but a passive dummy which did nothing but take and hold the title to the real estate conveyed to it. It served no business purpose in connection with the property and was intended to serve only as a blind to deter the creditors of one of the partners. It was but a sham to be disregarded for tax purposes. . . .

NOTE

1. *Once a dummy, always a dummy?* Can a corporation shift back and forth, depending on its business activities in the taxable year in question, from one status to another?

2. *Other cases.* Three wholly owned subsidiaries of the Air Reduction Corporation entered into contracts with their parent employing the subsidiaries as agents to manage and operate designated manufacturing plants and to sell the output of these plants. The

parent was to furnish working capital, executive management, and office facilities. The subsidiaries agreed to pay all profits to the parent except for 6 per cent on their outstanding capital stock, which was in each case nominal in amount. Title to the plants and related equipment was in the subsidiaries, but these assets were offset by loans payable to the parent. In National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949), the Supreme Court held that the entire operating profit, not merely the retained 6 per cent, was taxable to the subsidiaries, citing Lucas v. Earl and related cases. The Court went on:

> What we have said does not foreclose a true corporate agent or trustee from handling the property and income of its owner-principal without being taxable therefor. Whether the corporation operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent. [336 U.S. at 437.]

In Interstate Transit Lines v. Commissioner, 319 U.S. 590 (1943), a parent corporation was denied a deduction under §162(a) for a payment to its wholly owned subsidiary to defray the subsidiary's operating deficit for the taxable year, despite the fact that by contract it was entitled to the subsidiary's profits and was to reimburse the subsidiary for its losses. The Court held that the subsidiary's operating deficit was not an expense of the parent's business. The case was complicated by the fact that the subsidiary was organized to engage in operations (intrastate transportation in California) that were forbidden to the parent because it was a foreign corporation. The Court was not called upon to decide whether the parent's payments could be treated as an additional investment in the subsidiary to be offset against the money or property received by the parent if and when it sells or liquidates the subsidiary.

See Fishing Tackle Products Co. v. Commissioner, 27 T.C. 638 (1957), permitting a parent corporation to deduct under §162(a) amounts paid to a subsidiary to reimburse it for net operating losses sustained in manufacturing a product for sale to the parent, which distributed the product in question. The *National Carbide* and *Interstate Transit* cases were distinguished on tenuous grounds.

3. *Reference.* Cleary, The Corporate Entity in Tax Cases, 1 Tax L. Rev. 3 (1945).

Section C. Undistributed Corporate Earnings

1. *Unreasonable Accumulations of Surplus*

Sections 531-537 of the 1954 Code, imposing an "accumulated earnings tax," are derived, with substantial modifications, from §102 of the 1939 Code.

WORLD PUBLISHING CO. v. UNITED STATES

169 F.2d 186 (10th Cir. 1948), cert. denied, 335 U.S. 911, rehearing denied, 336 U.S. 915 (1949)

Before Phillips, Bratton and Huxman, Circuit Judges.

Huxman, Circuit Judge.

Section [531] of the Internal Revenue Code imposes an additional tax upon a corporation formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of being divided or distributed; and [the statute] provides that the fact that earn-

ings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax on shareholders unless the corporation shall prove to the contrary by a clear preponderance of the evidence.*

The Commissioner of Internal Revenue assessed additional taxes against the World Publishing Company, herein called the taxpayer, under the above Section for the years 1942 and 1943. The tax was paid, and a timely claim for a refund thereof was denied. A suit for its recovery was thereupon filed in the United States District Court for the Northern District of Oklahoma. The taxpayer has appealed from an adverse judgment.

The taxpayer, a corporation, publishing the Tulsa World, a daily newspaper in Tulsa, Oklahoma, was organized in 1906 with an original capital of $25,000.00. Through subsequent increases, its capital stock, as of December 31, 1943, stood at $1,000,000.00, consisting of 10,000 shares. Eugene Lorton, the president, owns 9,997 of these shares; his wife, Maud Lorton, owns one share; F. O. Larson, an employee, owns one share; and N. G. Henthorne, an employee, owns the remaining share. These parties have been the directors of the taxpayer since 1917. . . .

The taxpayer occupies an enviable financial status.[1] Thus it will be seen that in 1941, the net earnings and profits were $12,636.93, and the earned surplus was $562,521.98. In 1942, the net earnings had risen to $80,540.28, and the surplus was $643,062.26. In 1943, the net earnings increased to $96,564.21, and the earned surplus to $739,626.47. The total assets had increased from $1,570,166.29 in 1941, to $1,595,883.13 in 1942.

The taxpayer's paper grew from a small paper with a circulation of 7,000 to a present daily circulation of 70,000 and a Sunday circulation of 110,000. In 1917, it constructed a five-story building and installed large presses. In 1927, it added four stories to its building. The presses installed in 1917 were used presses and were reconditioned in 1927. On December 12, 1939, the directors set up a reserve of $250,000.00 for the purchase of new printing presses and the acquisition of a lot and building suitable for installing such presses. In 1940, the taxpayer purchased land adjacent to its building for $60,000.00, and announced that a new building would be erected. In July, 1941, a corporation under the name of the Newspaper Printing Corporation was formed. One-half of its stock was issued to the taxpayer and the other half to the Tulsa Tribune Company, publisher of the Tulsa Tribune, a competing paper in the City of Tulsa. From that time on, the Printing Corporation printed both papers, using taxpayer's mechanical plant, and the Tribune moved its office into the taxpayer's building.

It had been the settled practice of taxpayer throughout its history to finance its expansion and its mechanical equipment from earnings. The only loan ever executed by it was one of $50,000.00, in 1927, made to complete the additional four stories to its building.

At the meeting of the Board of Directors on December 21, 1942, a resolution was adopted setting aside an additional $150,000.00 for presses and accessory equipment, and $100,000.00 for the construction of the new building, and author-

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* Section 533 (a) of the 1954 Code requires only a "preponderance," instead of a "clear preponderance," of the evidence. — Ed.

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Year	Net Earnings and Profits	Earned Surplus	Year	Net Earnings and Profits	Earned Surplus
1934	$49,154.16	$488,176.20	1939	$18,826.42	$556,368.20
1935	19,871.07	488,047.27	1940	35,916.85	574,285.05
1936	34,238.10	502,285.37	1941	12,636.93	562,521.98
1937	18,250.89	520,536.26	1942	80,540.28	643,062.26
1938	37,005.52	557,541.78	1943	96,564.21	739,626.47

izing the President to proceed with plans for the purchase of new equipment. The war ensued and the purchase of the presses and the construction of the building were temporarily rendered impossible.

Under the arrangement with the Tribune, it was agreed that the Tribune was to pay one-half of the cost of the presses and accessory equipment, but there was some doubt about its ability to meet this commitment and it was perhaps necessary that taxpayer be prepared to advance the full cost of the presses and accessory equipment. At the end of 1942, the estimated cost of the building was $150,000.00, and the anticipated minimum cost of new presses and accessory equipment was $350,000.00.

The trial court's findings that the accumulation of the 1942 and 1943 surplus profits was in excess of the reasonable needs of the business, and that the taxpayer had failed to overcome the statutory presumption arising therefrom, are binding upon us if they find support in the record. Whether the accumulated reserves exceeded the reasonable needs of the business cannot be determined from a consideration of a single factor. It is necessary to consider and view all of the facts and circumstances in the light of the setting of the taxpayer in question. The factors which the court considered in reaching its conclusion are set out concisely and clearly in its detailed findings of fact as reported in 72 F. Supp. 886, and we concur therein. No useful purpose would be served by repeating in detail what is so clearly stated in the court's findings. It is significant that the accumulated earned surplus upon the taxpayer's books as of December, 1941, was greater than the estimated minimum cost of the new presses, accessory equipment and of the building, as also is the fact that the Tulsa Tribune Company was chargeable with one-half of the cost of the presses and accessory equipment. While there was evidence that the Tulsa Tribune Company was not presently able to meet its one-half of this obligation and that the taxpayer would perhaps be required to advance such share of the cost, the Tulsa Tribune Company's liability for its share of such cost is nevertheless pertinent in considering whether the reserves accumulated by the taxpayer were beyond the reasonable needs of its business. It is agreed that at the time these reserves were set up, the contemplated improvements could not be made on account of the war. No one knew when they would be made. It was reasonable to assume that a number of years would ensue. During this time the financial status of the Tulsa Tribune might well be expected to improve and the prosperous condition of the taxpayer to continue; and further earnings could, no doubt, be expected.

The minutes of the Directors' meeting of December 21, 1942, and other testimony upon the possibility of a diminution of profits was offered to establish the reasonableness of the reserves in question. But, if, as pointed out by the court, no further profits would be required because the reserves already exceeded the estimated cost of the contemplated improvements, such testimony has very little probative value. At most, it is but one of the factors to be considered. The court also pointed out that since the arrangement between the two publishing companies, taxpayer's profits had greatly increased notwithstanding high war time taxes. While it is not required that the reserves be spent in the year in which they are created, so long as there is a present need for the expenditure, the fact that they could not be spent for a number of years during which additional earnings might be expected, in the light of taxpayer's financial history, is a relevant factor to be considered. All this, as well as the other factors which are set out in the trial court's findings, reasonably tend to support the court's finding that the accumulation of the profits of 1942 and 1943 was in excess of the reasonable needs of the business.

The only remaining question is whether the taxpayer met the burden which the

statute places upon it to overcome the presumption that it was availed of for the prohibited purposes. Such presumption arises by virtue of a finding that it accumulated profits beyond the reasonable needs of its business. Taxpayer must then negative such purpose by a clear preponderance of the evidence. Such purpose need not be the sole purpose behind the accumulation. It is sufficient if it is one of the determining purposes. We think that the trial court's finding that it did not meet the requirement of the statute finds support in the record and is, therefore, binding on us. In all such cases as this, no single factor can be pointed to as controlling. A correct answer can be reached only in considering all of the facts and circumstances of the particular business under consideration and of the owner or owners of such business. When we consider the setting of taxpayer in its particular field of endeavor, it presents a bright picture. It had grown from an original investment of $25,000.00 to a corporation having assets of $1,595,883.13. Even during the depression years, it had enjoyed substantial profits. There was nothing in the picture to indicate that these profits would not continue or even increase. In addition to this, we have, for all practical purposes, a one-man corporation. Eugene Lorton owned all but three of the 10,000 shares of stock. He receives 99.97 per cent of all earnings distributed as dividends. If the earnings for 1942 and 1943 had been distributed to the stockholders, his surtaxes would have been increased in the amount of $69,520.35. All of these facts and circumstances tend to support the conclusions of the court that the corporation was availed of for the purpose of preventing the imposition of surtax upon its shareholders.

Affirmed.

PHILLIPS, Circuit Judge (dissenting).

. . . At a meeting of the Board of Directors of the World on December 21, 1942, Lorton, President of the World, reported that the Printing Corporation had been formed as a part of a long-range program of improvement and expansion; that the "through-put" of newspapers through the presses had more than doubled and had resulted in an "unsound functional operating position"; that it was imperative that a new press be purchased and installed and that a new building be constructed to house it "at the earliest practicable date," and that he estimated the minimum cost of the new press at $350,000, and the new building at $150,000. Those estimates in the light of future increase in costs were not merely conservative. They were too low. Thereupon, a resolution was adopted setting aside an additional $150,000 for a press and accessory equipment and $100,000 for the construction of the new building, and authorizing the President of the World to proceed with the plans to purchase a new press and accessory equipment and to construct the new building at the earliest practical date. However, the War ensued and the purchase of the press and accessory equipment and the construction of the building were temporarily rendered impossible.

It should be noted that, while the Tribune Publishing Company was to advance one-half of the cost of the press and accessory equipment, there was much doubt that it would be financially able to meet its commitment, and it was necessary for the World to be prepared to advance full cost of the press and accessory equipment.

In 1944, the World entered into a contract for the acquisition of a new press and accessory equipment. That contract was canceled. On May 25, 1945, the World entered nito a contract with Hoe & Company for the new press and accessory equipment, and made a down payment of $10,000. The World obligated itself to pay the full cost of such press and accessory equipment. The estimated cost of the new press and accessory equipment in May, 1945, was $636,489.38. The contract, however, contained an escalator clause, under which actual cost was to be computed on cost at time of delivery. The cost will be substantially in excess of the above figure.

An estimate furnished the World on August 18, 1945, by H. R. Lohman Company, of Tulsa, fixed the cost of the building at $300,000 and dismantling a building on the lot at $1600. Thereafter, a contract for the construction of the building was let on a cost plus basis. The cost will be greatly in excess of $300,000. Thus, it will be seen that the estimated cost of the press and accessory equipment and the new building in 1945 had increased to an aggregate of $938,089.38.

At the end of 1942, the World had quick assets, consisting of cash, stocks, and bonds, of $631,252.57, and current liabilities of $67,600.78, leaving an excess of $563,651.79 of quick assets over current liabilities. At the end of 1943, the World had quick assets of $859,099.53, and current liabilities of $187,837.93, leaving an excess of $671,261.60 of quick assets over current liabilities.

The World [paid] dividends in the years 1934 to 1941, inclusive, and in 1944 and 1945.

In the years 1942 and 1943, the World set aside its net earnings, after taxes, for the expansion program and did not pay any dividends. . . .

Mr. Lorton and Mr. Henthorne testified that the World withheld distribution of dividends in 1942 and 1943, in order to have funds available to finance the expansion program and not to avoid the imposition of a surtax upon its shareholders.

Had the World distributed as dividends in 1942 the $80,430.59, held by the Commissioner to be taxable under [§531], its quick assets at the end of 1942 would have been $483,221.20, or less than the then grossly inadequate estimate of the cost of the new building and the new press and accessory equipment, leaving no liquid funds for working capital. It is obvious that the reserve set aside at the end of 1942 was not in excess of the reasonable needs of the business of the World.

The excess of quick assets over current liabilities at the end of 1943 was $671,261.60. Viewed in the light of the earlier estimate of the cost of the new press, accessory equipment, and building, it was not necessary to withhold the distribution of dividends in the amount of $70,997.44. But, we know that by the end of 1943, costs had greatly increased and it is obvious from what it did, that the World revised upward its estimate of the cost of the press, accessory equipment, and building at the end of 1943. By May, 1945, the estimated cost of the press and accessory equipment was $636,489.38, and by August, 1945, the estimated cost of the building was $301,600. Clearly, the addition of $70,997.44 to the reserve at the end of 1943 was needed to meet justly anticipated increases in costs. In fact, it now appears that the reserves were substantially below the cost of the new press, accessory equipment, and the building, even if the Tribune Publishing Company should pay half of the cost of the press and accessory equipment, which is unlikely.

When the arrangement entered into with the Tribune Publishing Company was negotiated, $60,000 was advanced to the Printing Corporation by the World and the Tribune Publishing Company. No further advances were required. After the first six months, the Printing Corporation operated at substantial profits which were distributed monthly to the World and the Tribune Publishing Company, the Printing Corporation being a mere printing agency of the World and the Tribune Publishing Company.

The question is whether or not the World was availed of for the purpose of preventing the imposition of surtax upon its shareholders through the medium of the permitted earnings or profits, instead of being distributed as dividends. Section [533(a)] provides that the fact that earnings and profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders, unless the corporation by the clear preponderance* of the evidence shall prove to the contrary. The trial court found that the World has not met that burden. The findings of the

* See editor's note, supra page 616. — Ed.

trial court indicated that it placed strong reliance on the fact that the earned surplus of the World in 1941, 1942, and 1943 was in excess of the December, 1942, estimate of the cost of the new press and accessory equipment, and the building, even if the obligation of the Tribune Publishing Company to bear one-half of the cost of the press and accessory equipment should not be met. The trial court also stressed heavily the fact that the expansion program lay in the indefinite post-war future.

I cannot agree with the fact that the press and accessory equipment could not be immediately purchased and the fact that the building could not be constructed until the cessation of the War were pertinent considerations. The presses were old and could only be operated at 50 per cent of capacity. The load of the presses was increased when the arrangement was made to print both newspapers in the World plant. The fact that is was necessary for the World to acquire a new press and accessory equipment and to construct a new building in which to house them at the earliest possible date cannot be doubted. It was imperative that the World be in a position to act quickly when it became possible to purchase a new press and accessory equipment and construct the building. Surely, a business enterprise, with obsolete and badly worn equipment, might, during the War period, legitimately set aside a reserve fund to replace that equipment when available, and to construct the building necessary to house such equipment. To do so would be ordinary business prudence.

Undoubtedly, the World could have paid its earnings out in dividends and later borrowed, from Mr. Lorton, the money needed to purchase the press and accessory equipment and construct the building, but it was under no legal obligation to follow that course. It had the legal right to pursue the policy it had followed consistently throughout its history.

Moreover, I think the trial court erred in giving consideration to earned surplus. The cost of the new press and accessory equipment and the building would have had to be paid out of quick assets, not out of earned surplus, and as I have shown above, the quick assets in 1942 and 1943 were not in excess of a reasonable estimate of the cost of the new press and accessory equipment and the building when the reserves were increased in 1942 and 1943.

The argument is made that dividends of $47,000 and $45,000 were distributed in 1945 and 1946, respectively. The World could not determine, with certainty, that it would be able to make large earnings in 1945 and 1946. Newsprint was scarce. It was rationed severely. Advertising space had to be greatly curtailed. There was a short period when the World was unable to print any advertising whatever. It seems to me it was altogether reasonable for the World to set aside funds on hand to meet its imperative expansion program and it was not required to run the hazard of obtaining that necessary reserve from uncertain future earnings.

Aside from the fact that had dividends been declared in 1942 and 1943, the income tax liability of Mr. Lorton would have been greatly increased, it seems to me there is nothing in this record to justify the conclusion of the trial court. It is my opinion that, under the undisputed facts, the dividends accumulated were not beyond the reasonable needs of the business of the World, and that the World was not availed of for the purpose of preventing the imposition of surtax upon its shareholders. . . .

For the reasons indicated, I would reverse and remand, with instructions to enter judgment for the refunds claimed.

NOTE

1. *"Reasonably anticipated needs."* Section 537, providing that the term "reasonable needs of the business" includes the "reasonably anticipated" needs of the business, was enacted in 1954. Would it have aided the taxpayer in World Publishing Co.?

The Senate Report on the 1954 Code (p. 318) says of §537:

> It is intended that this provision will make clear that there is no requirement that the accumulated earnings and profits be invested immediately in the business so long as there is an indication that future needs of the business require such accumulation. In any case where there exists a definite plan for the investment of earnings and profits, such corporation need not necessarily consummate these plans in a relatively short period after the close of the taxable year. However, where the future needs of the business are uncertain or vague, or the plans for the future use of the accumulations are indefinite, the amendment does not prevent application of the accumulated earnings tax.

The Senate Report also states (pp. 69-70):

> If the retention of earnings is justified as of the close of the taxable year, subsequent events should not be used for the purpose of showing that the retention was unreasonable in such year. However, subsequent events may be considered to determine whether the corporation actually intended to consummate the plans for which the earnings were accumulated.

For cases in which §537 has been construed, see Sterling Distributors, Inc. v. United States, 313 F.2d 803 (5th Cir. 1963) (plans sufficiently definite, even though later abandoned); Motor Fuel Carriers, Inc. v. United States, 322 F.2d 576 (5th Cir. 1963) (plans too indefinite, even though later consummated).

2. *Presumptions, burden of proof, burden of going forward, etc.* Under §532, a corporation is subject to the accumulated earnings tax if it is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed." What is the relationship between this provision and the statutory presumptions — if that is what they are — of §533(a) (unreasonable accumulation shall be "determinative of the purpose to avoid the income tax with respect to shareholders" unless corporation proves to contrary by preponderance of evidence) and §533(b) (if corporation is a mere holding or investment company, this fact shall be "prima facie evidence of the purpose to avoid the income tax")? Before coming to a firm conclusion, note these 1954 innovations in the accumulated earnings tax:

(a) Section 534, relating to the burden of proof on the issue of unreasonable accumulations, in Tax Court proceedings. Query: is a notice of deficiency "based in whole or in part on the allegation" that there has been an accumulation beyond the reasonable needs of the business only if there is an explicit allegation to that effect in the notice itself? Whenever the revenue agent who proposed the notice of deficiency based his recommendation on such an allegation? Whenever the government relies on such an allegation in the Tax Court proceeding? Why is the new procedure confined to Tax Court proceedings?

(b) Section 535(c)(1)(A), providing, in effect, that even if the accumulated earnings tax is applicable, it shall not be imposed on any part of the taxable year's earnings and profits that is "retained for the reasonable needs of the business." Does this provision come into play if the corporation had reasonable needs, but in fact retained the earnings primarily to avoid income tax on its shareholders?

For some of the procedural difficulties introduced by the 1954 reforms, see Young Motor Co. v. Commissioner, 316 F.2d 267 (1st Cir. 1963); R. Gsell & Co. v. Commissioner, 294 F.2d 321 (2d Cir. 1961); Wagman, Taxation of Accumulated Earnings and Profits: A Procedural Wrangle, 37 Taxes 573 (1959).

Procedural problems aside, if the accumulation is undeniably beyond the reasonable

needs of the business, what kind of evidence might be introduced by the taxpayer to satisfy the requirement of §533(a)?

LION CLOTHING CO. v. COMMISSIONER
8 T.C. 1181 (1947)

BLACK, Judge: The principal question in this proceeding is whether petitioner is subject to the surtax on corporations imposed by [§531] for the calendar years 1940, 1941, and 1942. . . .

The respondent did not determine, and he does not contend that petitioner was "formed" for the prohibited purpose. He did determine and he does contend that petitioner was "availed of" for that purpose. It may also be noted at the start that the respondent did not determine, nor does he contend, that petitioner was "a mere holding or investment company" as that term is used in section [533(b)]. It is clear, of course, that petitioner is not a mere holding or investment company, but is a very active business enterprise, with a large volume of business, a considerable number of employees, and, evidently, a very large number of customers. Petitioner was formed for the purpose of engaging in the retail sale of clothing, and during the taxable years here involved it was engaged in that business and was quite successful in its operations.

The respondent did determine and he contends that during the taxable years here in question petitioner permitted its earnings or profits "to accumulate beyond the reasonable needs of the business," as that phrase is used in [§533(a)] of the code. By virtue of [§533(a)] the accumulation of earnings or profits beyond reasonable needs is determinative of a purpose to prevent the imposition of the surtax upon the shareholders, unless the corporation by a clear preponderance* of evidence proves to the contrary. See Whitney Chain & Mfg. Co., 3 T.C. 1109; affd., 149 Fed. (2d) 936. . . .

We think petitioner has met its burden of proof. Upon the evidence received at the hearing, we have found as ultimate facts that during the taxable years in question petitioner did not permit its earnings or profits to accumulate beyond the reasonable needs of its business and that it was not availed of for the prohibited purpose. The reason we think that earnings and profits of petitioner were not accumulated beyond the reasonable needs of its business is because petitioner has proved by evidence which seems convincing to us that in the year 1938 it adopted by appropriate corporate action a policy of accumulating a part of its net profits each year to be added to surplus "so that the company have funds for expansion or any unforeseen depression that might occur," and that this policy under all the circumstances of the case was a reasonable one and has been carried out, including the taxable years which we have before us. We do not think it can be said that a taxpayer's earnings were accumulated beyond the reasonable needs of the business where it is shown that the purpose of their accumulation is to retire mortgage indebtedness, to make improvements which will add to the convenience and efficiency of operation of the business, to expand operations by purchasing the interests of concessionaires, to accumulate some cash reserves as a bulwark against future depressions, and to meet unknown risks of the war and post-war period. All these things we think petitioner has proved with reasonable clarity. The facts with respect thereto are set forth in our findings of fact and need not be repeated in detail here. The following table taken from petitioner's balance sheets will show what might be termed its net quick assets and current liabilities in each of the taxable years:

* Since 1954, the statutory term has been "preponderance" rather than "clear preponderance" — ED.

Quick net asset resources	Dec. 31, 1940	Dec. 31, 1941	Dec. 31, 1942
Quick gross asset resources:			
Cash	$188,974.03	$218,143.98	$429,300.29
United States bonds	12,185.00	34,545.00	35,000.00
Union Trust Co. account:			
Cash	8,215.60	13,073.62	22,846.02
Notes receivable	8,932.09	12,231.15	13,438.06
Total	$218,306.72	$277,993.75	$500,584.37
Deduct current liabilities:			
Due concessionaires	$ 59,974.20	$ 67,252.02	$103,267.07
Accrued taxes	17,048.79	44,106.40	132,673.69
Mortgage payment	20,000.00	20,000.00	20,000.00
Due stockholders on demand	53,509.01	55,051.04	55,857.99
Total	$150,532.00	$186,409.46	$311,798.75
Quick net asset resources	$ 67,774.72	$ 91,584.29	$188,785.62

We think petitioner has established by satisfactory evidence that in each of the taxable years it was reasonable to add accumulations to its surplus so that it would have ample funds on hand without borrowing from banks to finance the following reasonable business requirements:

	Dec. 31, 1940	Dec. 31, 1941	Dec. 31, 1942
Installation of new elevator	$ 40,000.00	$ 40,000.00	$ 40,000.00
Installation of new fixtures	50,000.00	50,000.00	50,000.00
Purchase of Hafter interest	100,000.00	100,000.00	100,000.00
	$190,000.00	$190,000.00	$190,000.00

In addition to the above, we think petitioner has established that if and when, after the taxable years in question, clothing becomes more plentiful in supply it will be necessary to increase the size of its inventories. Petitioner estimates that $100,000 will be needed for this purpose. We have no reason to doubt the bona fides of the estimate, considering the very large annual volume of petitioner's business. Also, when [wartime government restrictions] on credit are removed it will be necessary to increase the size of its accounts receivable. Petitioner estimates that $50,000 will be required for this purpose. Thus it will be seen that substantial amounts of cash will be necessary for these purposes, even though it may turn out that petitioner has overestimated them. When all these facts are taken into consideration, we think they are sufficient to show that in none of the taxable years did petitioner accumulate its earnings beyond the reasonable needs of the business. In 1940, the first taxable year which we have before us, petitioner's net profits before taxes were $59,353.69. Of this amount, it paid $12,742.88 to the Federal Government in income and excess profits taxes, distributed $11,000 to its stockholders as dividends, and added $35,610.81 to earned surplus. In 1941 petitioner's net profits before taxes were $104,716.15. Of this amount, $37,248.19 was paid to the Federal Government in income and excess profits taxes, $15,000 was distributed to stockholders as dividends, and $52,467.96 was added to earned surplus. In 1942, the last of the taxable years which we have before us, petitioner's net profits were $182,725.74. Of this amount, petitioner paid $116,733.44 to the Federal Government in income and excess profits taxes, disbursed $20,000 to stockholders in dividends, and added $45,992.30 to earned surplus.

Thus we see from the foregoing facts that, while petitioner in the taxable years before us had large earnings, it paid large taxes to the Federal Government, disbursed substantial cash dividends to its stockholders, and added substantial

amounts to its earned surplus. In the light of the facts recited in our findings of fact, we think the additions which petitioner made in each of the taxable years to its earned surplus were reasonable in amount and were accumulated to meet the legitimate needs of the business and not to prevent the imposition of the surtax on its stockholders.

One of the cases which respondent cites and relies upon is Whitney Chain & Mfg. Co., supra. We think the facts of that case are very unlike those present in the instant case, and, therefore, it is clearly distinguishable. In the *Whitney Chain & Mfg. Co.* case the taxpayer had loans outstanding to its stockholders in the amount of $347,800 and an investment in an unrelated corporation in the amount of $382,800. Largely because of these facts, we held that the taxpayer corporation was availed of in the taxable year for the purpose of preventing imposition of the surtax upon its stockholders through the medium of permitting its earnings or profits to accumulate instead of being distributed.

In the instant case petitioner had no outstanding loans to stockholders. On the contrary, petitioner was indebted to its stockholders in the respective taxable years in the following sums: 1940, $53,509.01; 1941, $55,051.04; and 1942, $55,857.99. These amounts were payable to stockholders on demand. Also petitioner, unlike Whitney Chain & Mfg. Co., supra, had no investments in unrelated corporations. It is true that in the taxable years it owned some stock in the Hafter Co. which operated in petitioner's place of business a women's ready-to-wear department, but this was a closely related business. Petitioner had $7,763.38 invested in this Hafter Co. stock which it had acquired in 1934. The evidence shows that this women's ready-to-wear department operated by the Hafter Co. had grown to be quite profitable and the acquirement of the remainder of this Hafter Co. stock was one of the expansion plans which petitioner had in view in accumulating some of its profits each year and adding them to surplus. Petitioner estimated at the end of 1942 that $100,000 would be required to buy out the stock interest of the Hafter brothers in the Hafter Co. It turned out that more than this amount was required, for in 1946 petitioner bought the 75 shares of Hafter Co. stock from the Hafter brothers for $127,000.

More like the instant case than Whitney Chain & Mfg. Co., supra, is General Smelting Co., 4 T.C. 313, in which we held in favor of the taxpayer on an issue similar to the one we have here, on the ground that the taxpayer's business was highly competitive and that in 1938 it decided upon a plan of modernization of its plant which was to and did extend over a period of several years. See also Dill Manufacturing Co., 39 B.T.A. 1023.

We hold that respondent erred in determining that the surtax under the provisions of [§531] of the code should be imposed upon petitioner's net income for each of the taxable years 1940, 1941, and 1942. Needless to say, our decision in petitioner's favor covering the taxable years before us is based upon the evidence as to those years and is no indication as to what might be the decision covering future years. Any decision for a future year would, of course, depend upon its own facts. . . .

Decision will be entered under Rule 50.

NOTE

1. *May mighty oaks from little acorns grow?* What is "the" business, as this term is used in §533(a)? The Regulations state that a corporation's business "is not merely that which it has previously carried on but includes, in general, any line of business which it may undertake." Regs. §1.537-3(a). Does this mean that a small grocery store may aspire to become a department store or a nationwide chain of stores — or to monopolize the

manufacture and sale of widgets? The Regulations under the 1939 Code, Regs. 118, §39.102-3(b), included the sentence just quoted, but went on to warn that "a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax." This sentence was dropped in 1959. In defining "reasonable needs," the Regulations speak favorably of an accumulation "to acquire a business enterprise through purchasing stock or assets," but disapprove of "investments in properties or securities which are unrelated to the activities of the business of the taxpayer corporation." Regs. §1.537-2(b)(2) and §1.537-2(c)(4). In which of these categories should we place the acquisition of the Hafter stock by the Lion Clothing Company?

2. *The business needs of subsidiaries and other affiliated corporations.* The *World Publishing Co.* opinion states that the taxpayer owned 50 per cent of a second corporation (Newspaper Printing Corporation). If the expansion plans had been sufficiently definite to justify an accumulation by the taxpayer itself, would its position have been weakened by an arrangement providing that Newspaper Publishing Company would purchase the building and equipment with funds made available by the taxpayer, either in the form of loans to Newspaper Publishing Company or by the purchase of additional stock? See Regs. §1.537-3(b). The use of an 80 per cent benchmark in this provision of the Regulations stems from the Senate Report on the 1954 Code (p. 70), unaided by any explicit statutory authority.

If the business needs of another corporation can be taken into account, must the relationship between the corporations be that of parent-subsidiary, or will a brother-sister affiliation be sufficient? See Regs. §1.537-2(c)(3); Latchis Theatres v. Commissioner, 214 F.2d 834 (1st Cir. 1954); Factories Investment Corp. v. Commissioner, 39 T.C. 908 (1963).

In Fine Realty, Inc. v. United States, 209 F. Supp. 286 (D. Minn. 1962), involving the same enterprise that was before the court in *James Realty* (supra page 422), the court looked to the business needs of the enterprise as an entity in determining the reasonableness of one corporation's accumulations, but only after it had held that §269 was applicable to the organization of the other corporations so that only one $25,000 surtax exemption was permissible.

3. *Accumulations to pay corporate debts and to redeem stock.* In Helvering v. Chicago Stock Yards Co., 318 U.S. 693 (1943), involving a one-man corporation that was accumulating earnings for the purpose, among others, of paying off certain obligations of its subsidiaries, the Court suggested that the taxpayer's stockholder, had the taxpayer's surplus been distributed to him, could have equally well paid off the obligations in question. Does this suggest that despite a corporation's capital requirements, the §531 tax may be imposed if the earnings could have been distributed to the stockholders and reinvested by them in the corporation? In Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197 (4th Cir. 1957), this suggestion was rejected on a showing that a distribution would have been subject to a tax rate of 89 per cent in the shareholder's hands.

If at the time of organization the corporation issues both common stock and notes or bonds to its organizers, is retirement of the debt at or before maturity a reasonable need of the business? Note the reference in Regs. §1.537-2(b)(3) to a "sinking fund for the purpose of retiring bonds issued by the corporation." In the *Chicago Stock Yards Co.* case, supra, there is a suggestion that the payment of long-term obligations might not be a satisfactory excuse for the accumulation of surplus if the obligations might be readily refinanced at the due date. Despite this suggestion, the payment of corporate debts is often regarded as a reasonable need of the business without regard to the possibility of refinancing the obligations. See, for example, Gazette Telegraph Co. v. Commissioner, 19 T.C. 692 (1953), involving a corporation that on organization (a) issued common stock of a par value of $250,000 and ten-year promissory notes of a face amount of $250,000 to its organizers, and (b) borrowed $400,000 from a bank, to acquire assets of a net value of about $900,000. Within about four years, both the notes and the bank loan were paid off. The court found that the notes were bona fide, that the capitalization was not too "thin," and that payment of the obligations was a reasonable need of the business that justified the accumulation of earnings.

It seems less likely that the redemption of common or preferred stock will be regarded as a proper reason for accumulating surplus, though special circumstances might justify an accumulation for this purpose. See Gazette Publishing Co. v. Self, 103 F. Supp. 779,

784 (E.D. Ark. 1952) (elimination of potentially disruptive minority stock interest); Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960) (accumulation to redeem stock may be a reasonable business need; United Steelworkers Union, collective bargaining agent of taxpayer's employees, filed supporting brief as amicus curiae).

See Herwitz, Stock Redemptions and the Accumulated Earnings Tax, 74 Harv. L. Rev. 866 (1961).

4. *The $100,000 minimum accumulated earnings credit.* By virtue of §535(c), a corporation may accumulate up to $100,000 of earnings and profits (over-all, not annually) without being subject to the accumulated earnings tax. This credit was first granted by the 1954 Code in the amount of $60,000; it was increased to $100,000 in 1958. To discourage the multiplication of corporate entities as a means of multiplying the allowable credit, §1551 was amended to apply to the accumulated earnings credit as well as the $25,000 corporate surtax exemption. Moreover, if an affiliated group of corporations claims the 100 per cent deduction for intra-corporate dividends authorized by the Revenue Act of 1964 (supra page 606), the group is entitled to only one $100,000 minimum accumulated earnings credit.

The $100,000 minimum credit is not allowed to a corporation that is a "mere holding or investment company."

5. *Publicly held corporations and the accumulated earnings tax.* How likely is it that §531 will be applied to a publicly held corporation? The only reported cases involving a corporation with a substantial number of stockholders are Trico Products Corp. v. Commissioner, 137 F.2d 424 (2d Cir. 1943), cert. denied, 320 U.S. 799, and Trico Products Corp. v. McGowan, 169 F.2d 343 (2d Cir. 1948), cert. denied, 335 U.S. 899, rehearing denied, 335 U.S. 913 (1949), where, although there were more than 2000 stockholders, six stockholders owned about two thirds of the total shares. After the corporation paid a total of about $3.2 million in §531 surtaxes and interest, a minority stockholder brought a stockholder's derivative action against the directors for subjecting the corporation to the §531 penalty. This action was settled by a payment of about $2.5 million by the defendants to the corporation. See Mahler v. Trico Products Corp., 296 N.Y. 902, 72 N.E.2d 622 (1947); Note, Derivative Actions Arising from Payment of Penalty Taxes Under §102, 49 Colum. L. Rev. 394 (1949). What conditions would have to be present for a successful stockholder's action of this type? What would have to be alleged and proved in such an action?

The House version of the 1954 Code specifically exempted corporations with more than 1500 shareholders if no more than 10 per cent was held by any one family. The proposal was rejected by the Senate, partly because publicly held corporations would often be unable to prove their right to the exception because their records would not disclose how much stock was owned by any one family, and partly because "this tax is not now in practice applied to publicly held corporations. . . ." (S. Rept., p. 69.)

See also Hedberg-Freidheim Contracting Co. v. Commissioner, 251 F.2d 839 (8th Cir. 1958), imposing the accumulated earnings tax on a corporation whose stockholders were equally divided on dividend policy. In the tax case, it was shown that one of the stockholders had urged at a directors' meeting that a substantial distribution be made because the reasons for accumulating earnings and profits in past years no longer existed. He then read into the minutes a statement to the effect that he had been advised by the company's accountants and counsel that "if the company does not pay out in dividends as much cash as can reasonably be spared at this time, it will lay itself open to liability for [the accumulated earnings tax]," that "the withholding of further reserves cannot be justified," and that "in case this motion is not carried, each dissenting director will be held personally responsible for any [accumulated earning tax] levied against the company."

6. *References.* The 1954 changes in the accumulated earnings tax are discussed in Cohen, Phillips, Surrey, Tarleau, and Warren, The Internal Revenue Code of 1954: Carry-overs and the Accumulated Earnings Tax, 10 Tax L. Rev. 277, 299-306 (1955).

For more general discussions of §531, see Cary, Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c), 60 Harv. L. Rev. 1282 (1947); Rudick, Section 102 and Personal Holding Company Provisions of the Internal Revenue

Code, 49 Yale L.J. 171 (1939); Economic Effects of Section 102 (Tax Institute Symposium, 1951); Hall, The Taxation of Corporate Surplus Accumulations (Joint Committee on the Economic Report, 82d Cong., 2d Sess. 1952), reviewed by Cary, 6 Nat. Tax J. 197 (1953); Bolan, Section 102: A Persistent Menace to Closely-Held Corporations, 27 St. John's L. Rev. 1 (1952). See also Chommie, Surtax Avoidance and Extra Taxation of Corporate Earnings in the United States, United Kingdom, and Canada, 12 Tax L. Rev. 279 (1957).

HALL, THE TAXATION OF CORPORATE SURPLUS ACCUMULATIONS

Joint Committee on the Economic Report, 82d Cong., 2d Sess. 11-13 (1952)

In the absence of a comprehensive integration of the corporate and personal income taxes, Congress has endeavored to meet the undistributed profits tax problem in two ways: First, enactment of [§531] and its predecessor sections. In substance, this approach has been to declare that corporate earnings may not remain idle — there must be either corporate use of such earnings if retained, or they must be distributed to stockholders for their employment. Personal surtax avoidance through the corporate device is recognized and countenanced so long as undistributed corporate earnings are put to a productive use. Section [531] is not an undistributed profits tax; it may, however, create the appearance of being an undistributed profits tax because of its application to undistributed income (tax base) when idle or unemployed surplus accumulations become unreasonable in amount. Because it is a penalty tax it necessarily operates negatively rather than positively. It is erratic and imprecise in its treatment of the prohibited surplus accumulations. Its erratic and imprecise character is a compound of the administrative discretion which determines its activation with reference to particular taxpayer corporations and the difficulties of applying any reasonable accurate standard of measurement to the liquid assets (resulting from surplus accumulation) for which alleged corporate use may or may not find justification. As a *penalty* tax, its purpose is not directly and of itself to produce revenue, but instead to "force" either corporate use of earnings, if retained, or their distribution in dividends. The personal and corporate income taxes are the taxing instruments the revenue yield of which will reflect the capabilities of [§531]. As with any penalty device direct revenue yield is inverse to its effectiveness, assuming adequate administration.

The second method of meeting the undistributed profits problem was through a general positive levy on all retained corporate earnings at rates (1936) ranging from 7 per cent to 27 per cent (undistributed profits tax of 1936-39). This surtax on undistributed profits was automatic in its application. It was intended to encourage the distribution of corporate earnings without reference to the business use to which such earnings could be put if retained by the corporation. In other words, there was no exemption from tax, even though the corporate profits were needed in the business, which profits, if retained and invested, would presumably give rise to increased profit flow and dividend distributions in the future. The only method of avoidance of this tax was by distributing the whole of the corporate net earnings. The progressive character of the tax rates operated to increase tax pressure cumulatively for distribution as the corporate earnings became larger. The undistributed profits tax was a step in the direction of integrating the corporate and personal taxes, and, to that extent, in the words of the committee of the National Tax Association on Federal Taxation of Corporations, "was of real significance in that it marked a recognition of the importance of the inequity involved in the failure to bring corporate savings fully and promptly

to account for personal income tax purposes." This tax experiment came to an end in 1939. Since then (as well as before), the only barrier to tax avoidance through corporate surplus accumulations is [§531].

Certain of the more important differences between [§531] and the undistributed profits tax of 1936 may be summarized as follows:

1. Section [531] is a penalty tax and thus negative in character; the undistributed profits tax was a general levy on all retained corporate earnings and thus was positive and automatic in its application.

2. Section [531] is directed only to the idle or unjustified surplus accumulations; the undistributed profits tax applied to the total of the undistributed earnings.

3. Existing corporate liquidity is a factor of *large* importance in the determination as to whether or not [§531] is applicable; existing corporate liquidity was of no importance under the undistributed profits tax, because the tax applied to the annual corporate earnings remaining undistributed.

4. Section [531] is designed to "force" out as dividends only those corporate earnings which are not of active legitimate employment within the corporation; the undistributed profits tax was intended to apply tax compulsion toward the distribution of all profits.

5. Section [531] favors corporate savings if actively employed — the investment function; the undistributed profits tax penalized all corporate saving and favored the consumption function.

6. Section [531] should not be considered as performing an integrating function as to the corporate and personal taxes; the undistributed profits tax did provide a partial integration of the corporate and personal taxes.

7. Section [531] does not discriminate in general against the small and growing enterprise where growth is conditioned upon retaining and investing earnings; the undistributed profits tax did discriminate against small and growing enterprises by taxing the retained, reinvested earnings.

8. Section [531], in comparison with the undistributed profits tax, favors — if not forces — secular growth of productive capacity, and accentuates, in some measure, the amplitude of the business cycle; while the undistributed profits tax tended to retard secular growth of productive capacity, and to reduce probably the amplitude of the cycle.[1]

9. Section [531] does not apply to a corporation unless the Bureau of Internal Revenue initiates and makes a deficiency assessment under the section; the undistributed profits tax was self-assessed by the corporation. . . .

NOTE

Why tax undistributed profits? Taxes on undistributed corporate earnings, like those imposed by §531 and by the now extinct undistributed profits tax, have usually been proposed primarily because of the possibility that undistributed corporate earnings may permanently escape the individual income tax. Two other arguments in favor of such levies have been advanced from time to time. If corporate earnings are paid out as dividends, it is argued that the shareholders will compare all competing investment opportunities before deciding whether it is desirable to reinvest in the corporation that paid the dividends. If the corporation retains the earnings instead of declaring dividends, however, the directors may decide to expand the corporation for prestige or for other irrational motives. Moreover, it is argued that retained earnings are likely to be channeled by the corporation into investment, whereas dividends may be used by the stockholders for the purchase of consumption goods. If the national economic policy at any particular time is to foster consumption rather than investment, it may be desirable to encourage higher dividends rather than corporate reinvestment.

[1] It has been argued that large and active corporate surpluses will lead to overexpansion of productive capacity and initiate a recession; it is also contended that corporate surpluses serve to cushion the shock of a depression and to assist in recovery. For a brief discussion of the undistributed profits tax in relation to the corporate surplus and cyclical aspects, see M. S. Kendrick, The Undistributed Profits Tax (Washington, D.C.: The Brookings Institution, 1937), pp. 41-64 and 86-91.

How effectively would these objectives be served by §531 or by the undistributed profits tax? Section 531 clearly has its principal effect on closely held corporations, and apparently the undistributed profits tax also had more of an impact on small than on publicly held corporations. Lent, The Impact of the Undistributed Profits Tax, 1936-1937 (1948). Is it likely that the stockholders of such corporations would use the dividends differently than the directors would have used retained earnings?

See Rudick, Effect of the Corporate Income Tax on Management Policies, 2 Howard L. Rev. 232, 233-249 (1956).

2. *Personal Holding Companies*

Sections 541-547 of the 1954 Code, imposing a personal holding company tax, are derived, with minor modifications, from §§500-508 of the 1939 Code.

O'SULLIVAN RUBBER CO. v. COMMISSIONER
120 F.2d 845 (2d Cir. 1941)

Before L. HAND, CHASE and FRANK, Circuit Judges.

FRANK, Circuit Judge.

This is a petition for review of a decision of the Board of Tax Appeals, reported at 42 B.T.A. 721, which found a deficiency for 1935 in personal holding company tax of $4,198.37 and a penalty of $1,049.59.

In the disputed year petitioner was a dissolved corporation in process of liquidation. It sold its business of selling rubber heels and dissolved in 1932; since then it has not engaged in business, but has endeavored to liquidate as rapidly as possible. The original sales price, after defaults in payments, was reduced in 1935, and notes, bearing interest payable semi-annually and with serial maturities beginning in 1936, were taken for the unpaid balance of $340,000 due on the adjusted price. Prior to 1935 it had distributed in liquidation about $7 per share, but in that year, the amount available being small, it made no distribution. At least 80 per cent of its income in 1935 was derived from interest, and at least 50 per cent of its outstanding stock was owned by not more than five individuals. It came, therefore, directly within the definition of "personal holding company" in [§542(a)(1) and §542(a)(2)], unless it was not then a "corporation."

[The court held that the taxpayer, although in the process of winding up its affairs, was still a "corporation."]

But, urges the petitioner, the personal holding surtax was enacted to remedy the evil of the "incorporated pocket book," deliberately created to reduce the personal taxes of those who created them, and, therefore, to impose the tax upon a corporation in petitioner's position is a perversion of the Congressional purpose. We may assume that the taxpayer here was not deliberately aiming to relieve its stockholders from personal taxation. It is, however, abundantly clear that Congress, in correcting an evil, is not narrowly confined to the specific instances which suggested the remedy. "Of course, all personal holding companies were not conceived in sin — many were organized for legitimate personal or business reasons; but Congress has made little distinction between the goats and the sheep." [1] In enacting the very section being applied here, Congress was attempting to foreclose the defense, available under [§531] that the accumulation of profits was responsive to a legitimate business need. See Committee on Ways and Means, 73d Cong., 2d Sess., House Report No. 704, p. 12:

[1] Rudick, Section 102 and Personal Holding Company Provisions of the Internal Revenue Code 49 Yale L.J. (1939), 171, 203.

The effect of this system . . . is to provide for a tax which will be automatically levied upon the holding company without any necessity for proving a purpose of avoiding surtaxes.

Cf. Committee on Finance, 73d Cong. 2d Sess., Senate Report No. 558, p. 15. It is suggestive that an earlier revenue bill, that of 1928, proposed by the House Committee on Ways and Means, contained in section 104, a definition substantially identical with [§531], but that it was stricken by the Senate because:

As in the case of all arbitrary definitions, the effect was to penalize corporations which were properly building up a surplus and to fail to recognize business necessities and sound practices. Committee on Finance, 70th Cong., 1st Sess., Senate Report No. 960, p. 12; cf. Committee on Ways and Means, 70th Cong., 1st Sess., House Report No. 2, p. 17.

Having before us indisputable proof from the exactitude of [§542(a)] itself, reinforced by the Committee reports, that Congress wished to establish objective criteria for imposition of the tax, we cannot, by probing into corporate motives, undertake to relieve from the alleged harshness of a particular application of the statute. The Board of Tax Appeals, therefore, was correct in sustaining the deficiency asserted in personal holding company surtax. . . .

The decision of the Board of Tax Appeals is affirmed.

WILSON BROS. & CO. v. COMMISSIONER

170 F.2d 423, cert. denied, 336 U.S. 909 (9th Cir. 1948)

Before Denman, Chief Judge, and Stephens and Orr, Circuit Judges.

Orr, Circuit Judge.

This cause is before us on a petition for a review of a decision of the Tax Court making a redetermination of deficiencies determined by the commissioner of personal holding company surtax for the calendar years 1938 to 1942. It is conceded that petitioner is a personal holding company as defined by [§542(a)] of the Internal Revenue Code.

The Tax Court affirmed a determination of the Commissioner of Internal Revenue that for the purpose of computing the personal holding company surtax the petitioner was not entitled to deduct, under the provisions of [§545(b)(8)] of the Internal Revenue Code, amounts claimed for depreciation and expenses of two boats for the years 1938 to 1942, inclusive. Deficiencies determined by the Commissioner were substantially reduced by the Tax Court.

The corporation was organized in 1928, and was engaged in lumber mill operations until 1938, after which time its only business was the care of securities held by it and the collection of dividends and rent. The two boats in question were transferred to the petitioner corporation shortly after its inception, but were "laid up" in 1929 after serving for several months as transporters of lumber to various ports on the West Coast. Thereafter the corporation sought purchasers or lessees for the boats. Although several offers were received, no disposition of the vessels was effected. They have been kept moored and have remained under the care of a watchman who has been responsible for their maintenance. No rent or other compensation for the use of the boats has been received since they were withdrawn from use in 1929.

Petitioner was unable to establish to the satisfaction of the Commissioner that it came within either or all of the three conditions contained in [§545(b)(8)]. In fact, petitioner admits that the decision of the Tax Court, based on a literal reading of the applicable provisions of the Internal Revenue Code is correct, but insists that [§545(b)(8)] should be construed and applied in accord with its spirit rather than its letter. His argument is that a construction of [§545(b)(8)] in ac-

cord with its purpose rather than its letter would require a deduction in computing the income tax of a personal holding company wherever a deduction is allowed for an individual. The legislative history of the act is set out at length in petitioner's brief and it is argued that a business such as conducted by petitioner was intended by Congress not to lie within the application of [§545(b) (8)].

The premise to this argument is that the adoption of [§545(b)(8)] in 1937 envisaged no more than a means of preventing individuals from escaping the full amount of their income tax liability through the device of transferring property [the expenses and depreciation of which could not be deducted by the individual] to wholly owned corporations and taking depreciation and expense deductions from the corporate income tax liability. In the instant case it is urged that an individual owner of the two boats would have been entitled to deductions for maintenance expenses and depreciation under [§212 and §167(a)(2)] of the Internal Revenue Code.

Arguments of a similar nature have been made in other cases. We think a clear, satisfactory and complete answer to the contention was made in the case of O'Sullivan Rubber Co. v. Commissioner, 2 Cir., 120 F.2d 845, 847. We concur in the statement of that court "that Congress, in correcting an evil, is not narrowly confined to the specific instances which suggested the remedy."

Prior to 1942 an individual owner of boats held as were the boats in this case would have been unable to take depreciation and expense deductions because the vessels were not used in a trade or business. In that year [§212 and §167(a)(2)] of the code, were [enacted], to allow such deductions for property held for the production of income; however, the amending statute referred expressly to individuals. No change was made in the case of personal holding companies.

The failure to alter the provisions of [§545(b)(8)] in 1942 is significant of a Congressional intent contrary to that suggested by petitioner. . . .

Petitioner cites cases in support of the thesis that statutes should be construed to incorporate the intent of Congress and to avoid absurd results. The cases so cited deal with broad statutory language as applied to situations that were patently not within a reasonable interpretation of the apparent statutory policy. Section [545(b)(8)], however, is explicit in terms, and evinces a reasonable intent on the part of Congress to distinguish between personal holding companies and other taxpayers. That the particular instance which gave rise to [§545(b)(8)] is not presented by these facts does not militate against its application to them. O'Sullivan Rubber Co. v. Commissioner, supra.

The decision of the Tax Court is affirmed.

NOTE

1. *Disallowance of some expenses of personal holding companies.* Section 545(b)(8) was aimed primarily at incorporated yachts, country estates, etc. Since the rent received from a 25 per cent stockholder for the use of corporate property is "personal holding company income" under §543(a)(6), why was §543(b)(8) necessary? Section 543(a)(6), it might be noted, has been applied in the same mechanical fashion as other personal holding company provisions. In Hatfried, Inc. v. Commissioner, 162 F.2d 628 (3d Cir. 1947), §543(a)(6) was held to embrace the rent received by a corporation from a hotel leased by it to its sole stockholder and operated by him as an ordinary business enterprise. Section 223 of the Revenue Act of 1950 provided that for taxable years ending in 1946-1949 *only,* §543(a)(6) shall not apply to rents received for property used by the lessee in a bona fide commercial, industrial, or mining enterprise.

A different, and permanent, corrective is adopted by the second sentence of §543(a)(6), adopted in 1954 and amended in 1964.

2. *Personal service income.* Section 543(a)(7) throws into the category of personal

holding company income amounts received under certain personal service contracts. For another line of attack upon such arrangements, see Commissioner v. Laughton, supra page 401.

3. *The personal holding company provisions in practice.* The personal holding company provisions are studded with traps for the unwary. "Incorporated pocket books" of the kind which the sections were intended to deflate are ordinarily operated today only under the surveillance of attorneys and accountants who see to it that income is either sufficiently diversified or promptly distributed so that no personal holding company tax is paid. For the year 1958-1959, personal holding company schedules were filed by about 6300 corporations with aggregate corporate income of $320 million; only 400 of these corporations paid personal holding company taxes, and the aggregate tax paid was about $0.56 million on undistributed income of about $0.84 million. No doubt some of this liability was incurred by corporations that stumbled into the trap in ignorance; but even with the best of supervision, the personal holding company is a dangerous instrument. See Saxon Trading Corp. v. Commissioner, 45 B.T.A. 16 (1941); Morris Investment Corp. v. Commissioner, 156 F.2d 748 (3d Cir. 1946); Safety Tube Corp. v. Commissioner, 168 F.2d 787 (6th Cir. 1948).

In some circumstances, a corporation that becomes entangled in the meshes of §541 may be able to escape its full rigors by a distribution at a later date of "deficiency dividends" under §547.

4. *Foreign personal holding companies.* Foreign personal holding companies are dealt with by §§551-557. Because the corporation itself may be beyond American jurisdiction, each United States stockholder is taxed directly on his proportionate share of the corporation's undistributed income. Taxing the stockholder on undistributed income was held constitutional in Eder v. Commissioner, 138 F.2d 27 (2d Cir. 1943), despite the fact that the undistributed income was "blocked" and could not have been transferred to the United States.

In 1962, this technique was adopted so as to tax some United States shareholders of so-called "controlled foreign corporations" on some of the corporation's undistributed income. For a summary of the complex provisions which achieve this result, see Slowinski, Foreign Income Provisions of H.R. 10650, 1963 So. Calif. Tax Inst. 109.

5. *Regulated investment companies, mutual funds, and real estate investment trusts.* Certain regulated investment companies (including mutual funds) may elect under Subchapter M (§§851-855) to be subject to corporate taxation on their undistributed income only. These corporations, which must distribute currently at least 90 per cent of their income, are treated as conduits through which the income from investments passes to their stockholders, and their long-term capital gains retain that character on distribution to the stockholders. The Revenue Act of 1951 added §851(e), extending Subchapter M treatment to investment companies making "venture capital" available to other corporations engaged in technological research and development, even though the investment company controls the corporations in which its funds are invested, a previously disqualifying condition.

Sections 856-858, enacted in 1960, provide that certain real estate investment trusts distributing at least 90 per cent of current income shall be treated as corporations, with the important exception that distributed income is to be taxed to the beneficiaries rather than to the trust. The "conduit" concept is patterned on the treatment of regulated investment companies.

6. *References.* For personal holding companies, see generally Cleary, Personal Holding Company Pitfalls, 11 N.Y.U. Inst. on Fed. Taxation 467 (1953); Rudick, Section 102 and Personal Holding Company Provisions of the Internal Revenue Code, 49 Yale L.J. 171 (1939); Greenfield, Personal Holding Company Status, 29 Taxes 795 (1951); Kooster, Tax Advantages and Hazards in Operating as a Personal Holding Company, 8 J. Taxation 101 (1958); Brainerd, United States Income Taxation of the Foreign Holding Company, 34 Taxes 231 (1956). For regulated investment companies: Rubin, Regulated Investment Companies, 28 Taxes 541 (1950). For real estate investment trusts and other real estate enterprises: Roberts and Schapiro, Real Estate Investment Trusts, 19 N.Y.U. Inst. on Fed. Taxation 1047 (1961); Berger, Real Estate Syndication: Property, Promotion, and the Need for Protection, 69 Yale L.J. 725, 745-755 (1960).

Section D. Creating the Corporation

Section 351 of the 1954 Code, governing transfers to controlled corporations, carries forward the basic principle of §112(b)(5) of the 1939 Code.

Section 368(c) of the 1954 Code, defining "control," is identical with §112(h) of the 1939 Code.

Sections 358 and 362, governing the basis of property acquired on an exchange, are based on §§113(a)(6) and 113(a)(8) of the 1939 Code.

If Jones organizes a new corporation, Jones, Inc., paying cash for its shares, neither he nor the corporation realizes income on the transaction. Jones has done no more than to buy property, and the corporation on original issue of its stock is not regarded as selling or exchanging property or as otherwise realizing income. The par value, if any, of the shares is irrelevant. See Regs. §1.1032-1 (a).* The tax consequences would be no different if Jones, Inc., were being organized not by a single individual but by the Jones Holding Co., Inc., or by Thomas, Richard, and Harold.

But suppose that Jones owns a business, now operated as an individual proprietorship, and that he proposes to transfer it to a newly organized corporation, Jones, Inc., in return for all of the stock of the new entity. The regulation just cited will prevent the corporation from realizing gain or loss. What of Jones? He has transferred property — his business or its constituent assets — for other property, viz., the stock of Jones, Inc. We have noted before that on a sale or exchange, the transferor realizes gain or loss if the value of the property received either exceeds or is less than the adjusted basis of the property given up, §1001, and that the entire amount of the realized gain or loss must be recognized unless some statutory exception is applicable, §1002. Since 1921, a statutory exception — now §351 of the 1954 Code — has provided for the non-recognition of gain or loss on most incorporations. Where this non-recognition provision is inapplicable, any gain or loss must be recognized, just as under the pre-1921 statute gain or loss realized on the creation of *any* corporation had to be recognized. Livingston v. Commissioner, 18 B.T.A. 1184 (1930).

In the simple, but common, situation just suggested, §351 will apply and Jones will report neither gain nor loss on the exchange. In accordance with the usual rule, however, non-recognition of gain or loss requires the old basis (of the property given up) to be carried over and applied to the stock received on the exchange. See §358(a). In the interest of simplicity, it is assumed that Jones got nothing but stock and that the corporation did not assume, or take property subject to, any liabilities.

If Jones sells the stock at a later date, he will (assuming no change in values) recognize his postponed gain or loss then.† The stock will ordinarily be a capital

* Until 1954, if the corporation at a later date bought back some of its own stock and then reissued it, it might realize profit or loss if the reissue price was more or less than the price it paid on reacquiring the stock. See Murphy, How to Handle Treasury Stock; Distinction Between Treasury Stock and Unissued Stock: Is There Any Justification for This? 10 N.Y.U. Inst. on Fed. Taxation 1161 (1952); Anderson, Gain or Loss to a Corporation Dealing in Its Own Shares, 1953 So. Calif. Tax Inst. 121.

Section 1032 of the 1954 Code provides that no gain or loss shall be recognized by the corporation in these circumstances.

† If the stock is held until death, however, Jones' heirs will get a basis equal to its value at the date of death, by reason of §1014.

asset, however, whereas the unincorporated business was not a united item of property but a conglomeration of assets, some capital (e.g., goodwill), some non-capital (e.g., inventory), some quasi-capital (i.e., subject to §1231, like real estate, machinery, and fixtures). Williams v. McGowan, supra page 570.

If the incorporation of a business does not comply with §351, gain or loss will be recognized on the exchange, and the basis of the stock will be its fair market value at the time of the exchange. Since the basis of stock received when a business or other appreciated or depreciated assets are transferred to a corporation depends upon whether the exchange was taxable when made, the applicability of §351 may come into question not only when the corporation is organized but also many years later, when the stock is sold.

Our man Jones is not the only one who must worry about a preservation of the old basis. Section 362(a) provides that if the transfer to the corporation was a tax-free exchange, the *corporation's* basis for the assets transferred to it shall be the basis they had in the hands of Jones. It has been held that the transferee corporation steps into the shoes of the transferor so that the total old basis is allocated among the various assets in the same way as when they were held by the transferor, rather than being re-allocated in proportion to market values at the time of the transfer. Birren v. Commissioner, 116 F.2d 718 (7th Cir. 1940).

Why this dual preservation of the old basis? Could tax avoidance result if only one of the parties retained the old basis, the other getting a basis equal to market value? Can inequity be produced by the existing statutory scheme?

See generally Hellerstein, Planning the Corporation, 7 Tulane Tax Inst. 416 (1958); Webster, A Check List on Incorporation, 35 Taxes 586 (1957).

FAHS v. FLORIDA MACHINE & FOUNDRY CO.

168 F.2d 957 (5th Cir. 1948)

Before HUTCHENSON, HOLMES, and MCCORD, Circuit Judges.

MCCORD, Circuit Judge.

Appellee, Florida Machine and Foundry Company, filed suit to recover additional income and excess profits taxes, aggregating $19,089.44, paid for the years 1941 and 1942 under protest. From a judgment for appellee taxpayer, the Collector takes this appeal.

The only question presented is the proper cost basis to be used by taxpayer in computing gain or loss on the sale of certain land it owned in 1941 . . .

. . . The basis to be used for property acquired by a corporation after December 31, 1920, through the issuance of its stock for property in accordance with [§351] is the same as it would be in the hands of the transferor. [§362(a)(1).] If, however, the issuance of the stock for property is not governed by [§351], the taxpayer's basis is the cost to it of such property, or the fair market value of the property on the date of acquisition. [§1012.]

The evidence reveals that for some years prior to 1912, Franklin G. Russell, Senior, as sole owner, operated a business known as Florida Machine Works on Riverside Avenue in Jacksonville, Florida. On May 31, 1912, he purchased a tract of land bordering on West Church Street in Jacksonville, to which location the plant was later moved.

About the year 1920, it was shown that the Senior Mr. Russell, who had little technical education for foundry and machine shop work, discussed with his son, Franklin G. Russell, Junior, the possibility of the son eventually succeeding him in the business. The son had graduated from college in 1916 with a degree in mechanical engineering and, with the exception of about two years spent as a soldier in World War I, had served since that time as an apprentice in the various

departments of his father's plant, later becoming assistant manager. When the location of the business was changed from Riverside Avenue to West Church Street, the son himself had planned and laid out the new plant installations. In 1921 the father and son entered into an agreement whereby the son would eventually receive a one-half interest in the business, if he remained with it and continued to operate the plant. In pursuance of this agreement, the Florida Machine and Foundry Company, taxpayer, was organized and incorporated on July 16, 1924. At the organization meeting on that date, the Senior Russell conveyed to the corporation all of the assets of the business which he then owned individually, including the tract of land in question, for stock in the corporation, with the shares thereof to be issued directly to himself, his son, and one share each to three other persons. The father received 1181 shares and his son 1176 shares, the father thereby retaining only a bare majority of the stock issued.

In 1941, the corporation sold a parcel of the land on West Church Street for $15,000. The March 1, 1913, value of this tract was [$7800]. On July 16, 1924, the date taxpayer corporation was organized, the fair market value of the tract sold was [$13,000].

In its 1941 return, the taxpayer claimed a loss on the above sale in the sum of [$11,000], using as its basis of value for the land sold, the amount of [$26,000], which was [claimed to be] the proportionate fair market value of the land sold as compared with the fair market value of the entire tract as of July 16, 1924, the date of organization of the corporation and acquisition of the land by taxpayer.* The Commissioner denied the validity of the basis used, on the ground that the transfer to the corporation on July 16, 1924, was really a non-taxable exchange of property for stock, as described in [§351] of the Code, and ruled that, for the purpose of computing taxpayer's gain or loss under [§362(a)(1)], the proper basis of value was the March 1, 1913 value in the hands of the transferor, Franklin G. Russell, Senior, or [$7800], so that instead of a loss of [$11,000] as claimed by taxpayer, there was a taxable gain of [$7200]. . . .

We are of opinion the district court's finding that Franklin Russell, Senior, was not in "control" of taxpayer corporation "immediately after the transfer" on July 16, 1924, and therefore, that [§351] did not apply, is abundantly supported by the evidence.[1] . . .

Appellant's contention that the son, Franklin Russell, Junior, by virtue of the agreement with his father in 1921, acquired an equitable one-half interest in the land involved, which thereafter placed him and his father, as joint transferors, in "control" of taxpayer immediately after the transfer, is not borne out by the evidence. We further find no merit in the argument that taxpayer should be

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* The District Court accepted the taxpayer's contention that the 1924 value (rather than the 1913 value) was controlling, but found that the property sold was worth $13,000 in 1924, rather than $26,000, as claimed by the taxpayer. All figures have been rounded off. — Ed.

1 The district court found:

". . . Obviously, Mr. Russell, Senior, owned far less than 80% of taxpayer's capital stock according to the stock register. There is no basis in the evidence to find that the issue of stock on July 16, 1924, and the interests in the corporation thereby represented, were other than bona fide. There is no evidence of subterfuge or evasion, — no evidence that Mr. Russell sought to conceal a personal control of the corporation by formally placing one half of the capital stock in his son's name. To the contrary, it appears that the entire transaction was regular and in good faith, for the declared purpose of bringing his son into the business as a one-half owner, so that the son could and would carry on this long-standing family business after the retirement of his father, who was then getting along in years. At the time of this transaction, the son was a mature and experienced man, 31 years old, fully competent by education and experience to take over and manage the responsibilities of the business, which he did. The uncontradicted evidence is that the son was the absolute owner of the stock issued to him; that he exercised all the privileges of ownership thereof, and paid income tax on the dividends therefrom. . . ."

required to use the basis of its transferor, Franklin G. Russell, Senior, because of the latter's failure to report the transfer in 1924. There can be no estoppel against taxpayer for the act of its transferor, who was not in control of taxpayer corporation immediately after the transfer, and who was shown to have acted in good faith. Cf. Portland Oil Co. v. Commissioner, 1 Cir., 109 F.2d 479; Orange Securities Corporation v. Commissioner, 5 Cir., 131 F.2d 662.

It follows that the proper basis for the land in question is its fair market value when acquired by taxpayer corporation on July 16, 1924.

We find no reversible error in the record, and the judgment is therefore affirmed.

NOTE

1. *Control "immediately after the exchange."* Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir. 1942), cert. denied, 317 U.S. 655, involved a transfer of appreciated property by an individual to a corporation in exchange for all its stock. Immediately after the stock was issued to him, he transferred more than 20 per cent of it by gift to members of his family. On a later sale of the transferred property, the corporation claimed a stepped-up basis on the ground that the incorporation fell outside of §351. The court held that the transfer was non-taxable:

> Though it was plainly enough [the transferor's] intention to create the petitioner [corporation] . . . in order to provide him with stock to give as he did to his relatives, he was under no obligation to make the gift. There is neither claim nor proof that he was bound to carry out his intention to give any of it away when he received the stock or that he was not free at any time up to the very moment he gave it away to change his mind and use it for any lawful purpose. . . .
>
> In the absence of any restriction upon his freedom of action after he acquired the stock, he had "immediately after the exchange" as much control of the petitioner as if he had not before made up his mind to give away most of his stock and with it consequently his control. [127 F.2d at 516.]

See also O'Connor v. Commissioner, ¶57,050 P-H Memo T.C., where the court found the requisite control to exist, although more than 20 per cent of the stock of a newly organized corporation was issued directly to creditors of the transferor of property. Referring to the *Florida Machine* case and others like it, the court said:

> Prior to the exchanges involved in those cases the transferors had entered into agreements under which others, to whom stock was issued subsequently to the exchange, had acquired an interest in the subject matter of the transfers or had acquired an interest in the stock to be issued therefor. On the basis of such factual situations, it was held that immediately after the exchanges the transferors were not the owners of the stock issued to others and therefore did not own the amount of stock required by the statute to constitute them in control of the corporations.

For the effect of an underwriting arrangement by which part or all of the stock received by the transferor is to be sold after the incorporation, see American Bantam Car Co. v. Commissioner, 11 T.C. 397 (1948), aff'd per curiam, 177 F.2d 513 (3d Cir. 1949); see also May Broadcasting v. United States, 200 F.2d 852 (8th Cir. 1953); National Bellas Hess, Inc. v. Commissioner, 220 F.2d 415, 225 F.2d 340 (8th Cir. 1955).

Does the "special rule" of §351(c), which is new in the 1954 Code, suggest that fleeting control is insufficient in those instances where the special rule is inapplicable?

See Mintz and Plumb, Step Transactions in Corporate Reorganizations, 12 N.Y.U. Inst. on Fed. Taxation 247 (1954).

2. *Estoppel and mitigation of statute of limitations.* For the issue of estoppel, and the related question of mitigating the effect of the statute of limitations under §1311, see pages 869-879 infra.

3. *Services.* What is the effect of the second sentence of §351(a), if there are two or more transferors, one of whom receives stock in exchange for his promise to perform serv-

ices for the corporation? What is the status of stock that is received in payment for services rendered in the past? See Regs. §1.351-1(a)(1)(i); Herwitz, Allocation of Stock Between Services and Capital in the Organization of a Close Corporation, 75 Harv. L. Rev. 1098 (1962).

On the problem of distinguishing between a transfer of industrial "know-how," secret processes and formulas, etc. and the performance of services, see Rev. Rul. 64-56, 1964-1 C.B. 133.

4. *Receipt of "boot."* Section 351(a) provides for non-recognition of gain or loss if property is transferred to a corporation "*solely* in exchange for stock or securities in such corporation." What if all other requirements are met, but the transferor receives some cash or other property "to boot"? This could occur, for example, if the transferee, either an existing corporation with cash on hand or a newly organized corporation which received property from one stockholder and cash from another, gave a transferor of property some cash as well as securities. Section 351(b) provides that the receipt of other property or money ("boot") results in the pro tanto recognition by the transferor of whatever gain is realized on the transfer. The reason is that to the extent of the "boot," the transferor has changed his investment in substance as well as in form; the "boot" does not represent a continuing interest in the transferred property, as do stocks or other securities of the transferee corporation.

It should be noted that where depreciated, rather than appreciated, property is transferred to a corporation, the receipt of "boot" does not take the transaction out of §351 so as to permit the recognition of loss. See §351(b). Of course, if the transaction is outside of §351 for some reason other than the receipt of "boot," loss can be recognized under the general rule of §1002. But recall that a loss cannot be taken on sales or exchanges between certain related persons. §267; Commissioner v. Whitney, 169 F.2d 562 (2d Cir. 1948).

5. *Receipt of "securities."* The term "securities" as used in §351 is not defined. In view of the tax treatment of "boot," it is reasonable to assume that short-term notes and similar instruments will be treated as the equivalent of cash or other property rather than as "securities." This possibility is not examined further here, since the term "securities" has been the subject of important judicial explanation under the tax-free reorganization sections, but it should be borne in mind. See pages 722 et seq. infra.

If non-recognition is granted on the theory that the taxpayer has changed his investment in form only, should all debt be treated as "boot," leaving only common and preferred stock for tax-free receipt?

6. *Assumption of indebtedness by transferee corporation.* If the corporation at the time of the exchange assumes an indebtedness of the transferor, he receives a benefit that may be the equivalent of "boot." The parallel is particularly pronounced if the transferor mortgages the property just before the exchange, keeps the cash thus raised, and then transfers the property for stock plus an assumption of the mortgage. In these circumstances he may be as well off as though he had received cash as "boot" from the corporation itself. In United States v. Hendler, 303 U.S. 564 (1938), it was held (under the somewhat parallel reorganization sections) that an assumption of the transferor's indebtedness constituted "boot." Besides promising future inconvenience, since virtually all incorporations of existing businesses and reorganizations include an assumption of liabilities, the decision threatened to confer stepped-up bases on both transferor and transferee in countless past transactions assumed to be tax-free when consummated. The Treasury, not sure whether the defense of estoppel would prevent the claims of stepped-up basis, hastened to relinquish its victory. Section 357(a) and §357(b), substantially the same as §112(k) of the 1939 Code, are the result. See Surrey, Assumption of Indebtedness in Tax-Free Exchanges, 50 Yale L.J. 1 (1940).

Assuming or taking subject to debt is treated as "boot" only in limited instances. Why then does such a transaction always require a downward adjustment of basis under §358(a) and §358(d)?

Section 357(c) is new in the 1954 Code. What is its purpose? See Bryan v. Commissioner, 281 F.2d 238 (4th Cir. 1960); Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961); page 441 supra.

7. *Recapture of investment credit and depreciation.* If depreciable property is trans-

ferred to a corporation under §351, the carryover of basis protects the transferor against a recapture of excess depreciation except to the extent of the gain recognized, if any; see §1245(b)(3) and §1250(b)(3).

As to a recapture of the investment credit of §38, see §47(b) (second sentence). Does it apply to transfer of property to a controlled corporation under §351?

8. *Unbalanced exchanges by two or more transferors.* Section 351 has dropped a requirement contained in its predecessor, §112(b)(5) of the 1939 Code, that "in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange." The clause gave rise to difficult questions of valuation, as well as to conflicting opinions on how the proportion of change was to be calculated and on what constituted a "substantial" change. Moreover, the purpose of the requirement was quite obscure. See Hoffman, The Substantial Proportionment Requirement of Section 112(b)(5), 5 Tax L. Rev. 235 (1950).

Though abandoning the "substantially in proportion" requirement, the 1954 Code points out that an exchange may have the effect of a gift or of the payment of compensation. §351(d)(3) and §351(d)(4). The Senate Report states (pp. 264-265):

> To the extent . . . that the existing disproportion between the value of the property transferred and the amount of stock or securities received by each of the transferors results in an event taxable under other provisions of this code, your committee intends that such distribution will be taxed in accordance with its true nature. . . . In any case in which the stock and securities received are not in proportion, the transaction will be treated as if the stock and securities had first been received in proportion and then some of such stock and securities had been used to make gifts, to pay compensation, or to satisfy obligations of any kind.

What is the relation of the second sentence of §351(a) to the foregoing? Suppose one person transfers property and another does not, but each gets 50 per cent of the stock. Has the control requirement, see §368(c), been met?

9. *The theory of economic continuity.* Is §351 applicable so long as the exchange satisfies its literal terms, or must there also be a showing that the transferors have not drastically altered their economic status? If a dozen independent businessmen transfer their separate businesses to a newly organized corporation, each receiving stock equal to the value of the assets he gives up, are their gains and losses to go unrecognized under §351? What if one of the transferors gets all of the common stock of the transferee corporation and the others get only preferred stock or bonds? See Holstein v. Commissioner, 23 T.C. 923 (1955).

In Rev. Proc. 62-32, 1962-2 C.B. 527, 530, the Internal Revenue Service announced that it would not issue advance rulings on whether "the transfer of appreciated stocks or securities to a newly organized investment company, as a result of solicitation by promoters, brokers or investment houses, will constitute nontaxable exchanges within the meaning of this section [§351]."

10. *Accounting matters.* For accounting problems arising on the transfer of an unincorporated business to a corporation, see Rooney v. United States, 305 F.2d 681 (9th Cir. 1962) (requiring taxpayers who transferred an agricultural crop to a newly organized corporation to allocate their expenses in raising the crop to the corporation rather than to their individual tax returns, under §482); Rev. Rul. 62-128, 1962-2 C.B. 139 (bad debt reserve must be taken into income on transferring unincorporated business to a corporation, despite §351). Must a cash basis taxpayer recognize income on transferring accounts receivable to a corporation? If not, is the income arising on collection of the receivables taxable to the transferor or to the corporation?

AQUALANE SHORES, INC. v. COMMISSIONER
269 F.2d 116 (5th Cir. 1959)

Before Rives, Chief Judge, and Cameron and Jones, Circuit Judges.

Jones, Circuit Judge.

The Messrs. Walker, father and two sons, were landscaping and grading con-

tractors as a partnership in the name of Walker Construction Company. In May of 1949 the partners acquired approximately 175 acres of land at Naples, Florida, at a price of something more than $69,000. Purchase money mortgages were given for a substantial portion of the price. In December of 1949 the Walkers caused the taxpayer, Aqualane Shores, Inc., to be incorporated under the laws of Florida. On January 10, 1950, the organization meeting of the incorporators was held. Ten shares of stock were issued to each of the three Walkers for $320 per share. Simultaneously the Walkers conveyed the land, except a few lots sold by the partnership, to the corporation. An agreement was executed at the same time between the Walkers and the corporation in which it was stated that the consideration for the transfer was $250,000, of which $9,000 was cash paid, an unpaid amount of $49,128.88 on the mortgages was assumed, leaving a balance of $191,871.12. The agreement then provided:

3. The unpaid balance of $191,871.12 shall be paid by the Purchaser to the Sellers in five equal annual installments, the first installment becoming due January 10th, 1951. Unpaid balances of principal shall bear interest from January 10th, 1950, at the rate of 4% per annum, payable annually on the anniversary of principal installments.

4. The Purchaser will (a) make all payments of principal and interest on said five mortgages promptly when the same shall become due; (b) pay all taxes and assessments levied against the land for the year 1950 and subsequent years before the same shall become delinquent; and (c) as to the balance of the sales price — $191,871.12 —, pay all principal installments, with interest, promptly when the same shall be due. And should the Purchaser in anywise fail in any of these respects for a period of 60 days, the Sellers may, at their option, declare any sums of money owing to them hereunder to be forthwith due and payable.

The land was, for the most part, mangrove swamp. It was the plan of the Walkers to develop the property as a residential subdivision by dredging canals and using the spoil to increase the elevation of the remaining property, thus converting the unusable swamp into desirable waterfront property. The Walkers originally contemplated doing the development work as a partnership and the work was underway before the conveyance to the corporation was made. The income tax return of the partnership reported the transfer to the corporation as an installment sale which resulted in a long-term capital gain. The corporation borrowed money and gave mortgages as security. Forrest Walker, the father, made two unsecured loans, each in the amount of $10,000, to the corporation.

During the years 1950, 1951, and 1952, the taxpayer's income tax returns computed gains from the sales of lots on the basis of an overall land cost of $250,000. The Commissioner of Internal Revenue determined that the basis of the property to the corporation taxpayer was $69,291, the same as the basis of the Walkers. Deficiencies resulting from the Commissioner's determination of the taxes were assessed. The Tax Court sustained the Commissioner. Aqualane Shores, Inc. v. Commissioner, 30 T.C. 519. The Tax Court found that, aside from the tax advantages to be gained, the principal purposes for incorporation were to facilitate the raising of capital and to expedite and simplify the processes incident to sales. It assumed, from the evidence, that the property when acquired by the corporation had a fair market value of approximately $250,000. After finding that the exchange of checks between the partnership and the corporation was a wash-out transaction,* the Tax Court concluded that the January 10th, 1950,

* The three partners paid for their stock in the taxpayer corporation with checks on their partnership bank account aggregating $9,600 on January 10, 1950, and on the same day the taxpayer issued a check on its bank account in the amount of $9,000 as the down payment on the land. The Tax Court concluded that these transactions "washed out" because neither the partnership nor the corporation had $9,000 on deposit, so that neither could have paid that amount to the other except by the exchange of checks. — Ed.

transaction did not create a bona fide debtor-creditor relationship between the corporation and the Walkers, and that the transfer was, in substance, a transfer of land solely in exchange for stock of the taxpayer and is governed by the provisions of [§351]. From this it followed, and the Tax Court so held, that the basis to the corporation is the same as the basis to the Walker partnership prior to the exchange pursuant to [§358]. From the decision of the Tax Court, entered in accordance with its opinion, the taxpayer corporation has appealed.

The corporation started in business with the land acquired from the stockholders and six hundred dollars in money, or such part of that sum as may have remained after the payment of its organization expense. The agreement between stockholders and corporation showed a corporate indebtedness for purchase money of $241,000 which was more than 96% of the recited purchase price of the land. Its equity was narrowly margined and its working capital was practically nil. Its only asset was an area of mangrove swamp. The only source from which the corporation could expect revenues was from the sale of lands. Only a very small part of the land had been cleared and filled. It was of a kind and character that required the expenditure of substantial amounts of money in order to put it in marketable condition. Funds for this purpose were borrowed. No payments of principal or interest were made by the corporation to the Walkers during the years 1951 through 1954, except a payment or credit of $8,000 made in 1950 upon the 1951 installment.

The taxpayer corporation relies heavily upon the opinion in Sun Properties, Inc. v. United States, 5 Cir., 1955, 220 F.2d 171, as being "on all fours" with its case. In the *Sun Properties* case the taxpayer was incorporated by the owner of property to whom three shares of one dollar par value stock were issued. The transferor then transferred to the corporation a warehouse building for a recited consideration of $125,000 payable in semi-annual installments of $4,000. At the time the sale was made the operation of the warehouse was very profitable. During the year in which the sale was made the net profits from operation of the warehouse were in excess of $21,000. The district court sustained the Commissioner's determination that the transfer of the property was not a sale but a contribution to capital. This Court concluded that there was no evidence that the transfer of property was a contribution to capital or intended as such. In the opinion which is here under review the Tax Court noted:

> We are not unmindful of the fact that some parts of the reasoning and language in Sun Properties, Inc. v. United States, supra, appear to be inconsistent with the result which we have reached here. However, it is axiomatic that each case of the type considered here must be decided on its peculiar facts. In our opinion the facts of the instant case, considered in their entirety distinguish it from the case of Sun Properties, Inc., and bring it within the ambit of the opinions of this Court and of the various Courts of Appeals which we have heretofore noted.

As this Court noted in its opinion in the *Sun Properties* case [220 F.2d at 175], "Evidence which may tend to prove that a transaction was a contribution to capital may be of many sorts." Cf. Rowan v. United States, 5 Cir., 1955, 219 F.2d 51. The taxpayer corporation, Aqualane Shores, Inc., after its exchange of checks with its incorporating stockholders had $600 of operating funds. Payment of what it had agreed to pay for the undeveloped land which the corporation had acquired could be made only if and when sales of the land were made and proceeds of such sales were received. The controlling consideration in determining whether the obligations of a corporation given by it as the recited consideration for the transfer of property are to be regarded as representing purchase money or as a security received in a [§351] exchange "is an overall evaluation of

the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc." Camp Wolters Enterprises, Inc. v. Commissioner, 22 T.C. 737, affirmed 5 Cir., 1956, 230 F.2d 555, certiorari denied 352 U.S. 826. The payment of obligations of the corporation to its transferors, the stockholders of the corporation, was dependent upon at the risk of the success of the venture. The obligations were a participation in the pot luck of the enterprise. Camp Wolters Enterprises, Inc. v. Commissioner, supra. The contract and the obligations of it are, we think, "securities" of the corporation within the meaning of the statute, 3 Mertens Law of Federal Income Taxation, Ch. 20, p. 119, §20.47. The Tax Court, after considering all of the factors, reached the conclusion that "there was in substance an exchange by the partners of property in return for a proprietary equity in the corporation equivalent for tax purposes (which are concerned with economic realities) to a transaction covered by the provisions of [§351]."

In the *Sun Properties* case the income from the property transferred was such as to require the conclusion that the obligation could be paid from it leaving the capital assets unimpaired. Here the property was not income producing and required expenditure of development costs to make it subject to profitable sale. The contract obligations clearly represented risk capital. The applicable precedent is to be found in *Camp Wolters Enterprises* rather than in *Sun Properties.* The decision of the Tax Court is correct. Its judgment is affirmed.

NOTE

"Sale" vs. §351 exchange. What tax advantage would be obtained from establishing that the 1950 transaction was a "sale" rather than an exchange under §351? Is a clue provided by the fact (30 T.C. at 523) that the 1950 partnership return of Walker Construction Company reported that it had sold the property on the installment basis and had realized a long-term capital gain?

Note how §1239 restricts the taxpayer's chance to get a "cheap" stepped-up basis for depreciable property by selling it to a controlled corporation.

SECTION E. THE CORPORATION'S CAPITAL STRUCTURE

Since interest is deductible while dividends are not, there is an obvious tax incentive to the use of debt as well as equity instruments as evidences of payment for the cash or property transferred to a corporation by its stockholders. Moreover, certain personal tax advantages will accrue to the organizers of the corporation, if they become creditors as well as stockholders of the corporation. If the corporation prospers, it may pay off its debt and the creditor-stockholders will realize income only to the extent that the payment exceeds the "adjusted basis" of the instruments paid off.* The income, if any, will be capital gain under §1232.

If the organizers hold only stock, however, amounts paid to them by the corporation (including a pro rata reacquisition of stock) are usually taxed as dividends, i.e., as ordinary income. See page 652 infra.

If the corporation fails, worthless stock, bonds, and other "securities" ordinarily give rise to long- or short-term capital loss under §165(g). For the scope of §165(g), and its exceptions, see supra pages 582-583.

* In this connection, §358 should be re-examined. Suppose assets with an adjusted basis of $60,000 and a market value of $150,000 are transferred to a newly organized corporation for 1000 shares of common stock without par value plus bonds of a total face amount of $50,000. What is the basis of the bonds? Would the result be different if the stock had a par value?

Some of the other ways in which corporate debt is encouraged by the Internal Revenue Code are encountered later in this book. For a study of the economic effect of these tax incentives, see Lent, Bond Interest Deduction and the Federal Corporation Income Tax, 2 Nat. Tax J. 131 (1949).

In an effort to exploit the tax advantages enjoyed by debt, taxpayers have on occasion gone too far and thereby lost out:

1. *Hybrid securities.* Where the corporation is not able to issue ordinary evidences of indebtedness, usually because of a fear of clogging its credit position, there have been attempts to get the same tax effect by issuing "hybrid" securities. These instruments look like preferred stock to creditors, but it is hoped that they will pass muster as bonds, debentures, or notes before the tax collector. Among the characteristics of such "hybrid" securities are the following: (a) they are held by the same persons and in the same proportions as the stock; (b) they are transferable only with stock; (c) they have far-off maturities, or no maturity dates; (d) the "interest" is geared to income or is discretionary with the directors; (e) payment of the "interest" or "principal" (or both) is subordinated to general creditors; and (f) they are issued only to stockholders and not for new consideration.

If too many of these features are found, the instruments will be treated as preferred stock rather than as evidences of indebtedness.* The leading case on the subject is John Kelley Co. v. Commissioner, 326 U.S. 521 (1946).

Suppose an instrument is labeled preferred stock, but has all the other indicia of a bond. Can the issuing corporation deduct the "dividends" on the ground that they constitute "interest" on indebtedness? The deduction has occasionally been permitted. United States v. Title Guarantee & Trust Co., 133 F.2d 990 (6th Cir. 1943); Choctaw, Inc. v. Commissioner, ¶53,397 P-H Memo T.C. In the former case the misleading label was employed to avoid recognition of debt on the issuer's balance sheet; in the latter case, it was apparently intended to give the investor an opportunity to claim the dividends received credit granted to corporate stockholders by §26(b)(1) of the 1939 Code. (This allowance, which is now a deduction, is carried over by §243 of the 1954 Code.)

2. *Thin capitalization.* At the opposite extreme are the corporations that are so unconcerned about their credit standing that they can issue seemingly orthodox debt securities in an amount that overwhelms the common stock investment, e.g., bonds in the amount of $99,000 plus common stock against assets valued at $100,000. Here the problem is that the bonds, although containing ironclad indicia of debt, may be treated as the equivalent of stock for tax purposes because anyone buying such instruments would regard himself, in the light of the corporation's trivial equity, as a stockholder or potential stockholder and not as a bondholder. An obvious parallel is the bankruptcy treatment of stockholder advances as capital contributions rather than as loans where the corporation was inadequately capitalized. See Dobkin v. Commissioner, 15 T.C. 31 (1950), aff'd per curiam, 192 F.2d 392 (2d Cir. 1951).

* The House version of the 1954 Code contained definitions designed to indicate precisely what instruments would qualify for the interest deduction and for other tax privileges. But the Senate dropped these definitions, stating (S. Rept., p. 42): "Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks and securities will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments."

AMERICAN-LA FRANCE-FOAMITE CORP. v. COMMISSIONER

284 F.2d 723 (2d Cir. 1960)

Before LUMBARD, Chief Judge, and WATERMAN and MOORE, Circuit Judges.

MOORE, Circuit Judge.

By petition for review, petitioner, American-La France-Foamite Corporation, seeks to reverse so much of a decision of the Tax Court as denied petitioner a deduction of $506,887.06 in its 1951 income tax included in its return as a worthless debt. As a result of this disallowance, a deficiency in income tax of $266,558.13 was assessed.

The sole question presented is whether advances made during the years 1947 to 1951 by petitioner to International Meters, Inc. (IMI) represented capital contributions or loans. If they were loans, they were deductible in 1951, the year of the liquidation of IMI [§166]; if capital contributions, their deduction was limited by [§165(f) and §1211(a)].

The necessity for resolving this question (namely, loans or capital contributions) has arisen many times and doubtless will arise many times in the future. The solution of the problem which the courts face in the cases usually is difficult. The situations in which the facts are clear as to whether the advances should fall into one category or the other will rarely reach the courts; only the borderline cases will be litigated. As the Tax Court here quite accurately said, "the matter may not be completely free from doubt" but, since decision is necessary, it must be based upon "our best judgment on the entire record . . ."

The courts have sought to set up several guideposts along the path towards a correct and just decision. Thus, it is said that *"the intention of the parties* is a major factor in determining the true nature of the relationship" (Jennings v. United States, 7 Cir., 1959, 272 F.2d 842, 843). However, "intention" is often a highly artificial and hypothetical concept because most frequently business ventures originate and are carried on without any clear intent as to tax consequences. If the venture is directed from the start by tax counsel and accountants, it is likely that the advances will be definitely recognizable as loans or capital contributions. Absent, however, any such direction, the ultimate outcome, the success or failure of the venture, may well dictate a preferred tax treatment which was not intended or even foreseen at the inception of the venture.

The "substance" rather than the "form" of the transaction has frequently been stressed. . . . Gilbert v. Commissioner, 2 Cir., 1959, 262 F.2d 512, certiorari denied, 1959, 359 U.S. 1002. In final analysis, it is from that composite of all the facts that an attempt must be made to create a probably non-existent intent and to decide in relation to accepted business practices whether the "loan" pan of the scale is heavier than the "capital contribution" pan.

The venture giving rise to this controversy (except for some preliminaries in 1946) commenced in 1947 when petitioner purchased for $50,000 fifty-one per cent (51%) of IMI's common stock, 400 shares of preferred stock and a $9,000 note. IMI had been in existence for some six years primarily to exploit a parking meter which by means of two meters on one head could control two parking spaces. The general plan was to have petitioner manufacture the meters and IMI to act as the selling agent. For various reasons the operation did not proceed as rapidly or as successfully as contemplated. IMI had virtually no money during its corporate existence so that all financing had to come from petitioner during the five years of their joint enterprise. Substantial advances were made during these years by petitioner and certain repayments largely from the assignments of meter purchase contracts were received. Nevertheless, the balance against IMI contin-

ued to increase.[1] Finally in 1951 the contract between petitioner and IMI was terminated and IMI was liquidated, its assets sold and the proceeds applied against petitioner's account, reducing the balance to the $506,887.13 here involved.

Although IMI existed as a separate corporation, it was petitioner which made its operations possible. For all practical purposes, the parking meter was just another item petitioner was manufacturing and marketing through a selling agent. Petitioner's stockholders were told that "During the past two years, approximately, we [petitioner] have been developing and testing a new type of parking meter . . ." and "We recently acquired that company [IMI] and will have complete control of its operations." A year later after "We spent $148,700 on the Tavin Parking Meter project in 1947," stockholders were notified that "parking meters are coming off the production line for sales representative purposes and deliveries to customers should start in April." Towards the end, the report advised that "Losses were reduced from $122,535 in 1949 to $42,819 in 1950 and our advances to International Meters, Inc. in 1950 were relatively immaterial."

Petitioner to support a debtor-creditor relationship points to the fact that both petitioner and IMI on their books and financial statements treated the advances as loans; that the advances were not in proportion to the stockholdings and that the advances were partially repaid.

The Commissioner buttresses his stand by asserting that the "loans" were not made to a "going business" but were for the purpose of getting the business going; that no notes were given to evidence the so-called indebtedness; that no time was fixed for repayment; that no interest was charged; and that IMI's financial condition was so weak that repayment was entirely contingent upon the success of the venture.

Petitioner, in turn, cites cases showing that notes, maturity date and certainty of payment are not necessarily determinative. Rowan v. United States, 5 Cir., 1955, 219 F.2d 51, 55. . . . On their own particular facts, the courts in these cases have found that the weight of evidence justified the conclusion of a debtor-creditor relationship. These cases, however, only serve to create the doubt which the Tax Court said this case is not "completely free from." Yet, viewing in proper perspective the venture from beginning to end, it is difficult to reconcile these large advances, made to a company with no assets of any substance and no prospects other than the success of the venture, as "loans." See John Kelley Co. v. Commissioner, 1946, 326 U.S. 521; see also Gilbert v. Commissioner, 2 Cir., 1957, 248 F.2d 399, 407; Note, Thin Capitalization and Tax Avoidance, 55 Colum. L. Rev. 1054 (1955). The Tax Court has fairly analyzed the evidence and properly concluded that "the deduction for worthlessness of petitioner's investment must be governed by the provisions relating to capital assets rather than by the bad debt provisions."

The decision of the Tax Court was affirmed.

NOTE

1. *Income on collecting a "loan"?* If the corporation had prospered, would a repayment of the "loans" have constituted a disguised dividend to the creditor-shareholder? Given the business circumstances, is the court correct in suggesting that tax counsel and account-

[1]

Year	Balance	Year	Balance
1946	$ 53,983.80	1949	534,748.24
1947	98,717.20	1950	535,580.10
1948	364,998.57	1951	575,987.08

ants can assure that the advances will be recognized as loans or as capital contributions if they "direct" the venture from the start?

With the cases cited by the court, see Gooding Amusement Co. v. Commissioner, 236 F.2d 159 (6th Cir. 1956); Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956); Gilbert v. Commissioner, 262 F.2d 512 (2d Cir. 1959) (a later installment in the litigation cited by the court).

How would the result in the *Whipple* case, supra page 285, have been altered if the corporation to which the taxpayer made the disputed advances had been too "thin"?

2. *References.* Goldstein, Corporate Indebtedness to Shareholders: "Thin Capitalization" and Related Problems, 16 Tax L. Rev. 1 (1960); Caplin, The Caloric Count of a Thin Corporation, 17 N.Y.U. Inst. on Fed. Taxation 771 (1959); Bittker, Thin Capitalization: Some Current Questions, 34 Taxes 830 (1956), reprinted with minor revisions in 10 U. of Fla. L. Rev. 25 (1957).

SECTION F. DISTRIBUTIONS OF CASH AND PROPERTY — TAX STATUS OF THE SHAREHOLDER

1. *Distributions of Earnings by the Going Concern*

Section 316(a) of the 1954 Code, defining the term "dividend," is substantially the same as §§115(a) and 115(b) of the 1939 Code.

Section 301(c), prescribing how corporate distributions shall be taxed, is substantially the same as §§22(e), 115(b), and 115(d) of the 1939 Code.

a. "EARNINGS AND PROFITS"

Section 316(a) provides that any distribution either from earnings and profits accumulated after February 28, 1913, or from earnings and profits of the current year is a "dividend." Sections 61(a)(7) and 301(c)(1) provide that "dividends" shall be included in gross income. Any corporate distribution that is not a "dividend" — as that term is defined by §316 — is received tax-free but must be applied in reduction of the basis of the stock on which it is distributed. §301(c)(2). Once the stockholder has recovered his basis, non-dividend distributions are ordinarily taxed as capital gains, with an exception of minor importance for distributions out of increase in the value of corporate property accrued before March 1, 1913. §301(c)(3)(A) and (B); see Higginson v. United States, 81 F. Supp. 254 (Ct. Cl. 1948); Blauvelt v. Commissioner, 4 T.C. 10 (1944).

If we assume a corporation newly organized for cash, the reason for gearing the taxability of its distributions to its record of earnings and profits is clear enough. Until the corporation has engaged in profitable operations, any distribution to its original stockholders is a return of their investment rather than income. Once the corporation has realized profits, on the other hand, its distributions may pro tanto be fairly regarded as income to the stockholders.

The equity of §§316 and 301(c) is far less clear if we assume that after a period of corporate profits the stock changes hands and that before additional earnings arise (the next day, if you will) there is a distribution to the new stockholder. Has not *he* received a return of *his* capital? Sections 316 and 301(c) are inescapable, however, and to the extent of his share of the earnings and profits the surprised stockholder has realized income. This "miracle of income without gain" — the phrase is from Powell, Income from Corporate Dividends, 35 Harv. L. Rev. 363 (1922) — long ago was attested by the Supreme Court in United States v. Phellis, 257 U.S. 156, 171-172 (1921):

Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he was called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations — bought "dividend on," as the phrase goes — and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon.

How accurately can the purchaser tailor the price he offers for a share of stock to fit the income tax liability he will incur if a dividend is declared?

Whatever argument of equity may be urged against United States v. Phellis, it would no doubt be administratively unfeasible to tax each individual stockholder on dividends only to the extent that his corporation had had earnings after he purchased his shares. This suggests the question: if we can stomach the inequity arising in thousands of *Phellis* transactions, is there any reason for tying the taxation of corporate distributions to earnings and profits at all?

It is a curious fact that the Code, ordinarily so prodigal in the use of words, nowhere defines the term "earnings and profits," although the term has no counterpart in the field of corporation law. The term is partly explained by Regs. §1.312-6, and the effect of a few transactions on earnings and profits is prescribed by the Code. See §312 and §381(c)(2). See also the exhaustive discussion by Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law: Corporate Non-Liquidating Distributions, 89 U. of Pa. L. Rev. 865 (1941). Mr. Rudick's article is brought up to date by Albrecht, "Dividends" and "Earnings or Profits," 7 Tax L. Rev. 157 (1952); and see Andrews, "Out of Its Earnings and Profits": Some Reflections on the Taxation of Dividends, 69 Harv. L. Rev. 1403 (1956); Alexander, Some Earnings and Profits Aspects of the Internal Revenue Code of 1954, 7 Hastings L.J. 285 (1956); Mahon, New Rules as to Earnings and Profits, 13 N.Y.U. Inst. on Fed. Taxation 583 (1955); Katcher, What is Meant by Earnings and Profits, 18 id. 235 (1960); Bangor & Aroostook R. Co. v. Commissioner, 193 F.2d 827 (1st Cir. 1951), cert. denied, 343 U.S. 934.

The determination of earnings and profits is often no simple feat, especially when they must be traced through a series of corporate reorganizations or similar transactions. It may be necessary to go back many years to decide how a transaction should have been taxed under a now interred statute because of its effect upon earnings and profits.

Three more aspects of earnings and profits should be noted:

1. *Earnings and profits of the current year.* If a corporation has earnings and profits *in the taxable year,* any distribution will be taxable pro tanto, even though the corporation has a deficit. §316(a)(2). This provision has a curious ancestry. It was enacted in 1936 as a relief measure when the undistributed profits tax was in effect. That tax was imposed on the undistributed part of corporate income, computed by deducting "dividends" from total income. Unless a deficit corporation could treat distributions out of current earnings as "dividends" for this purpose, it would be unable to avoid the undistributed profits tax no matter how large its distributions to stockholders were. To enable such corporations to obtain a credit for "dividends" paid out of current earnings, §316(a)(2) was enacted. Apparently no thought was given to the effect of the new subsection

apart from the undistributed profits tax. Its impact can sometimes be avoided by postponing the distribution until the next year. If the corporation has no earnings in that year and still has a deficit, the distribution will be receivable tax-free since it will fall under neither §316(a)(1) nor §316(a)(2).

2. *Pre-1913 earnings and profits.* Note the importance in this area of March 1, 1913, the date on which the Revenue Act of 1913 (the first federal income tax imposed after the Sixteenth Amendment was adopted) became effective. A distribution of earnings and profits accumulated before this date is not taxed as a dividend, but is applied to reduce the basis of the taxpayer's stock, with any excess being taxed as a capital gain unless it comes out of a pre-1913 increase in the value of corporate property, as indicated above. By virtue of the second sentence of §316(a), however, pre-1913 earnings and profits may not be distributed until post-1913 earnings and profits have been exhausted; "earmarking" a distribution is not permissible.

These pre-1913 sources do not enjoy constitutional immunity from tax, Lynch v. Hornby, 247 U.S. 339 (1918), but Treasury attempts to obtain a repeal of the privilege have been defeated. See House Ways and Means Committee, 77th Cong., 2d Sess., Hearings on Revenue Revision of 1942, pp. 1692 et seq.; H.R. Rept. No. 2319, 81st Cong., 2d Sess., reprinted in 1950-2 C.B. 380, 418-419.

3. *"Dividend": state law vs. tax law definition.* The term "dividend" as defined for income tax purposes by §316(a) may not correspond with the term "dividend" under state law, with the result that a distribution may be a "dividend" under §316(a), although it impairs capital or is otherwise unlawful under state law. Conversely, it is possible for a distribution to constitute a lawful "dividend" under state law without qualifying as a "dividend" under §316(a). In the former instance, the "dividend" will ordinarily be taxable to the stockholder under the "claim of right" doctrine, notwithstanding a potential liability to creditors under state law. United States v. Lesoine, 203 F.2d 123 (9th Cir. 1953); but see Knight Newspapers, Inc. v. Commissioner, 143 F.2d 1007 (6th Cir. 1944).

b. DISGUISED DIVIDENDS

Just as the Code does not define "earnings and profits," so also it fails to define "distribution." We have already encountered two examples of disguised corporate distributions that will be taxed as "dividends" if the corporation has post-1913 earnings and profits:

1. Purported "salary" that is not compensation for services but rather a distribution to a stockholder-employee or to a donee of a stockholder. Supra page 270. A dividend may also be disguised as rent, royalties, or as the purchase price for property transferred to the corporation by the stockholders. If such payments are excessive, the excess will be taxed as a dividend. Cf. Staab v. Commissioner, 20 T.C. 834 (1953); Crabtree v. Commissioner, 22 T.C. 61 (1954).

2. "Interest" on hybrid securities or on evidences of indebtedness issued by an undercapitalized corporation that are the equivalent of stock. Supra page 642.

To these should be added:

3. Sales of corporate property to stockholders for less than fair market value, and rent-free use of corporate property. Timberlake v. Commissioner, 132 F.2d 259 (4th Cir. 1942); Regs. §1.301-1(j).

4. "Loans" by a corporation to its stockholders that are not intended to be repaid. See Regensburg v. Commissioner, 144 F.2d 41 (2d Cir. 1944); Werner, Stockholder Withdrawals — Loans or Dividends? 10 Tax L. Rev. 569 (1955).

5. Corporate "expenses" that are incurred to benefit stockholders, rather than to further the corporation's trade or business. In American Properties, Inc. v.

Commissioner, 262 F.2d 150 (9th Cir. 1958), it was held that the expenses of designing, constructing, and racing speed boats, paid by a one-man corporation, were not deductible under §162(a) by the corporation and constituted disguised dividends to the sole shareholder, who "had an insatiable desire for speed." See also Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956) (corporation's payments for creating and maintaining "a unique horticultural show place" at sole shareholder's farm disallowed under §162(a) and taxed as constructive dividends). But see Casale v. Commissioner, 247 F.2d 440 (2d Cir. 1957), holding that premiums on a policy insuring the life of the corporation's sole stockholder were not constructive dividends to him, reversing a Tax Court judgment based on the theory that the corporation "was no more than a conduit running from the insurer to [the stockholder], or his beneficiaries, with respect to any payments which might come due under the insurance contract." *Accord:* Prunier v. Commissioner, 248 F.2d 818 (1st Cir. 1957). But see Sneed, A Defense of the Tax Court's Result in Prunier and Casale, 43 Cornell L.Q. 339 (1958).

While a constructive dividend is more likely to be found if the stockholders share its benefits pro rata, it has been held that equal treatment is not indispensable. In Lengsfield v. Commissioner, 241 F.2d 508 (5th Cir. 1957), for example, distributions to several shareholders were taxed as dividends; the others, who did not participate, were related to the recipients and consented to the distributions. See also Paramount-Richards Theatres, Inc. v. Commissioner, 153 F.2d 602 (5th Cir. 1946).

The foregoing outline assumes that a purported "salary," payment of "interest," etc., is a constructive corporate distribution, to be taxed as a "dividend" under §316(a) to the extent of earnings and profits. The corollary of this theory is that an absence of earnings and profits will cause the payment to be applied in reduction of the basis of the stock under §301(c)(2). Is the "unreasonable" portion of a salary, however, necessarily a corporate distribution, with taxability dependent upon the existence of earnings and profits? Or is it simply a salary payment that is fully taxable under §61(a) to the recipient, regardless of earnings and profits, even though the corporation cannot deduct it? In Simon v. Commissioner, 248 F.2d 869 (8th Cir. 1957), the court held that corporate funds that had been diverted by stockholders to their own use were to be treated as "distributions," taxable only to the extent provided by §301(c). For a holding to the contrary, see Davis v. United States, 226 F.2d 331 (6th Cir. 1955), cert. denied, 350 U.S. 965.

See generally Comment, Disguised Dividends: A Comprehensive Survey, 3 U.C.L.A.L. Rev. 207 (1956); Toll, Constructive Dividends, 1951 So. Calif. Tax Inst. 211.

2. *Distributions in Complete Liquidation*

Section 331(a)(1) of the 1954 Code, relating to complete liquidations, is substantially the same as §115(c) of the 1939 Code.

Section 332 of the 1954 Code, relating to complete liquidations of subsidiary corporations, is substantially the same as §112(b)(6) of the 1939 Code.

Section 333 of the 1954 Code, permitting an election as to recognition of gain in certain complete liquidations, is substantially the same as §112(b)(7) of the 1939 Code.

Section 331(a)(1) provides that on a complete liquidation of a corporation the stock shall be treated as though it had been sold, so that the stockholder realizes

gain or loss on the difference between the adjusted basis of the stock he surrenders and the value of what he receives. Thus the earnings and profits account, so critical to the tax status of the distributions of a going concern, becomes irrelevant when the distribution is in complete liquidation. In analogizing a complete liquidation to a sale rather than to a dividend, §331(a)(1) carries forward a policy established in 1924, though for a period (1934-1936) liquidations were short-term capital transactions whereas a sale could give rise to either short- or long-term gain or loss. Is the analogy to a sale valid?

The fact that the corporate earnings and profits account is obliterated by a complete liquidation is of central importance to the progressive rate structure of the federal income tax. We have already noted that the earnings of a corporation, unlike those of a partnership or individual proprietorship, do not run the gauntlet of the individual tax rates when earned. Now we find that on a complete liquidation, the earnings may be received by the stockholder as capital gain. To be sure, they could be converted into capital gain by an alternate route: sale of the stock. But unless the *buyer* was assured of a painless way of extracting the earnings in the future, he might follow the *Phellis* suggestion (supra page 645) of discounting the amount he would pay for the stock by the tax he would have to pay in the future. Thus §331(a)(1) makes it possible to realize on corporate earnings at the capital gains rate, either by liquidating the corporation or by selling the stock to someone who contemplates a liquidation.

COMMISSIONER v. CARTER

170 F.2d 911 (2d Cir. 1948)

Before L. HAND, SWAN and CHASE, Circuit Judges.

SWAN, Circuit Judge:

This appeal presents the question whether income received by the taxpayer in 1943 is taxable as long-term capital gain, as the Tax Court ruled, or as ordinary income as the Commissioner contends. The facts are not in dispute. The taxpayer, Mrs. Carter, had owned for ten years all the stock of a corporation which was dissolved on December 31, 1942. Upon its dissolution all of its assets were distributed to her in kind, subject to all its liabilities which she assumed. In the distribution she received property having a fair market value exceeding by about $20,000 the cost basis of her stock, and she reported such excess as a capital gain in her 1942 return and paid the tax thereon. In the corporate liquidation she also received 32 oil brokerage contracts which the parties stipulated had no ascertainable fair market value when distributed. Each contract provided for payment to the corporation of commissions on future deliveries of oil by a named seller to a named buyer. The contracts required no additional services to be performed by the corporation or its distributee, and the future commissions were conditioned on contingencies which made uncertain the amount and time of payment. In 1943 the taxpayer collected commissions of $34,992.20 under these contracts. She reported this sum as a long-term capital gain; the Commissioner determined it to be ordinary income. The Tax Court held it taxable as capital gain. The correctness of this decision is the sole question presented by the Commissioner's appeal.

Mrs. Carter's stock was a "capital asset" as defined by [§1221] of the Internal Revenue Code. In exchange for her stock, she received the assets of the corporation upon its dissolution. The tax consequences of such a transaction are controlled by [§331(a)(1), providing that the liquidation distribution shall be treated as a payment in exchange for the stock; §1001, providing that the gain or loss shall be the difference between the adjusted basis of the stock and the "amount realized" therefor and that the "amount realized" is the sum of the money received

and the fair market value of any property received; and §1002, providing that the entire amount of the gain or loss shall be recognized unless otherwise provided] . . . From the foregoing statutory provisions, it is obvious that if the oil brokerage contracts distributed to the taxpayer had then had a "fair market value," such value would have increased correspondingly the "amount realized" by her in exchange for her stock and would have been taxable as long-term capital gain, not as ordinary income. Boudreau v. Commissioner, 5 Cir., 134 F.2d 360; Fleming v. Commissioner, 5 Cir., 153 F.2d 361. The question presented by the present appeal is whether a different result is required when contract obligations having no ascertainable fair market value are distributed in liquidation of a corporation and collections thereunder are made by the distributee in later years.

In answering this question in the negative, the Tax Court relied primarily upon Burnet v. Logan [supra p. 457]. . . .

The Commissioner argues that the *Logan* case is inapplicable because there the taxpayer had not recovered the cost basis of her stock while here she had. The Tax Court thought the distinction immaterial. We agree. The Supreme Court spoke of the annual payments as constituting "profit" after the seller's capital investment should be returned. Until such return it cannot be known whether gain or loss will result from a sale; thereafter it becomes certain that future payments will result in gain. No reason is apparent for taxing them as ordinary income. As this court said in Commissioner v. Hopkinson, 126 F.2d 406, 410, "payments received by the seller after his basis had been extinguished would have been taxable to him as capital gains from the sale of the property," citing Burnet v. Logan as authority.

The Commissioner also urges that the *Logan* case is distinguishable because it dealt with a sale of stock rather than exchange of stock for assets distributed in a corporate liquidation. This contention is answered by White v. United States, 305 U.S. 281, 288, and Helvering v. Chester N. Weaver Co., 305 U.S. 293, 295, where the court held that the recognition . . . of gains and losses on liquidations must for purposes of computation of the tax, be taken to be the same as that accorded to gains and losses on sales of property.* Consequently we agree with the Tax Court's ruling that the principle of the *Logan* case is applicable to a corporate liquidation where stock is exchanged in part for contracts having no ascertainable market value, and that future collections under such contracts are taxable as capital gain in the year when received if the distributee has previously recovered the cost basis for the stock.

The Commissioner's argument that such collections are analogous to the receipt of interest or rent upon bonds or real estate distributed in a corporate liquidation overlooks a significant distinction. Payment of interest or rent does not impair the value of the bond or real estate since each remains as a capital asset regardless of the number of payments. See Helvering v. Manhattan Life Ins. Co., 2 Cir., 71 F.2d 292, 293. But with respect to the oil brokerage contracts, under which no additional services were to be rendered by the payee, each payment decreases their value until, with the final payment it will be completely exhausted; and, if the payments be treated as income, the distributee has no way to recoup his capital investment, since concededly he has no economic interest in the oil producing properties and therefore no right to depletion deductions. Hence to consider the brokerage payments as ordinary income would produce a most unjust result and one quite unlike the result which follows the distribution of bonds or real estate in a corporate liquidation.

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* Section 115(c) of the 1939 Code was explicit on this point; the same rule is applicable under the 1954 Code by virtue of the cross reference in §331(c)(2). — Ed.

For the foregoing reasons we think the decision of the Tax Court correct. It is affirmed.

NOTE

1. *"Open" and "closed" liquidations.* Pursuant to Regs. §1.1001-1(a) ("only in rare and extraordinary cases will property be considered to have no fair market value"), the Internal Revenue Service has announced that it "will continue to require valuation of contracts and claims to receive indefinite amounts of income, such as those acquired with respect to stock in liquidation of a corporation, except in rare and extraordinary cases." Rev. Rul. 58-402, 1958-2 C.B. 15. The ruling cites a number of cases in which unusual claims and rights have been valued; see also Grill v. United States, 303 F.2d 922 (Ct. Cl. 1962) (right to receive part of royalties from release of movie "Gone With The Wind" held susceptible to valuation); Campagna v. United States, 290 F.2d 682 (2d Cir. 1961) (second mortgages on real estate); but see Nakatani v. Cullen, 5 A.F.T.R.2d 519 (N.D. Calif. 1959) (value of chose in action, in litigation, not determinable).

If a liquidation is treated as a "closed" transaction, but the amount ultimately realized exceeds or falls short of the value placed on the property at the time of the liquidation, is the taxpayer's gain (or loss) ordinary gain or loss, or capital gain or loss? Does this depend upon whether the contract or other asset received in the liquidation qualifies as a "capital asset" under §1221 and is the subject of a "sale or exchange," or can the post-liquidation receipts be related back to the liquidation and taxed as belated capital gain? If the shareholder receives a contract in a "closed" liquidation, how is his basis in the contract to be reflected in the post-liquidation years in which royalties or other payments under the contract are received? If the post-liquidation transactions produce a loss, is the *Arrowsmith* case (supra p. 532) applicable? See Grill v. United States, 303 F.2d 922 (Ct. Cl. 1962); Ayrton Metal Co. v. Commissioner, 299 F.2d 741 (2d Cir. 1962) (payments after liquidation of joint venture).

2. *"One-month liquidations" under §333.* Section 333 provides that the shareholders of a liquidating corporation may elect not to recognize their gain on the liquidation, if the transfer of all of the corporation's property occurs within one calendar month. The principal function of this provision is to permit a corporation holding appreciated assets but having no earnings and profits or cash (e.g., a real estate holding corporation that has regularly distributed its earnings to its shareholders) to be liquidated without the recognition of any gain. The stockholders, however, hold the distributed assets with a basis equal to the basis of the surrendered stock. §334(c). If the liquidated corporation had either earnings and profits or cash, gain is recognized pro tanto, and is taxed as ordinary income to the extent of the earnings and profits. Stock or securities acquired by the corporation after December 31, 1953, are treated as the equivalent of cash. Use of §333 is optional with the stockholders. Moreover, it provides for the non-recognition of gain only. If the liquidation produces loss rather than gain, the loss would be recognized under §331. See Eaton, Liquidation Under Section 112(b)(7), 38 Va. L. Rev. 1 (1952); Osenbach v. Commissioner, 198 F.2d 235 (4th Cir. 1952); Meyer's Estate v. Commissioner, 200 F.2d 592 (5th Cir. 1952).

3. *Tax-free liquidations of subsidiary corporations under §332.* Section 332 provides in substance that no gain or loss shall be recognized on the liquidation of a subsidiary corporation. The provision, which was enacted in an earlier form in 1935, was proposed by the Treasury as a measure to encourage the simplification of elaborate corporate structures. In the absence of such a non-recognition provision, unnecessary subsidiary corporations could be eliminated (if they were successful enterprises) only by paying a capital gains tax under the general rule, §331, applicable to complete liquidations. Unlike §333, §332 is not optional; moreover, it provides for the non-recognition of both gain and loss.

Section 332's basis provision, §334(b)(1), does not follow the usual practice of giving the property received on a tax-free exchange the same basis as the property given up, as does §358, for example. Instead, §334(b)(1) provides that, as a general rule, the transferee (the parent corporation) takes over the basis of the transferor — its subsidiary. This will be advantageous if the subsidiary has a high basis for its assets, but disadvantageous when its basis is low. If the parent corporation acquired the subsidiary for the sole purpose of

acquiring its assets though a liquidation, however, it seems more appropriate to treat the transaction as an acquisition of the assets, and to give the parent a basis for the assets equal to its cost for the stock, rather than the substituted basis provided by §334(b)(1). The so-called "Kimbell-Diamond" rule had this result under the 1939 Code, based on the theory that the acquisition of the subsidiary for the purpose of liquidation was in substance a single transaction, to be treated as though the assets had been acquired directly. Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir. 1951), cert. denied, 342 U.S. 827; see also Commissioner v. Ashland Oil & Refining Co., 99 F.2d 588 (6th Cir. 1938), cert. denied, 306 U.S. 661. The uncertainties of the "Kimbell-Diamond" rule led to the codification of §334(b)(2), which provides in substance that if the parent purchases 80 per cent of the stock of the subsidiary within a period of not more than twelve months, and liquidates it within two years thereafter, the basis of the property thus acquired shall be the same as the basis of the stock.

If a corporation wishes to avoid §332 in order to recognize loss on the liquidation of a subsidiary, can it accomplish its aim by selling some of the stock so that it owns less than 80 per cent? Before 1954, §112(b)(6) (the predecessor of §332) provided that a disposition of any stock by the parent between the time the plan of liquidation was adopted and the time it was consummated would take the transaction out of the tax-free category. This restriction was removed by the 1954 Code "with the view to limiting the elective features of the section." S. Rept., p. 255. Does this mean, by negative inference, that a sale to reduce ownership below 80 per cent will be effective? It was so held in Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956). See Colgan and Molloy, Tax-Free Liquidations of Corporate Subsidiaries Under Section 112(b)(6) of the Internal Revenue Code, 4 Tax L. Rev. 305, 333-334 (1949); Busterud, The Liquidation of Subsidiaries Under Section 112(b)(6), 58 Yale L.J. 1050 (1949).

4. *The liquidating corporation's income.* On the possibility that amounts received by the shareholders after a corporate liquidation (e.g., the payments on the contracts in the *Carter* case) may be taxed to the corporation, see pages 665-674 infra.

3. *Stock Redemptions and Partial Liquidations*

Section 331(a)(2) of the 1954 Code, relating to partial liquidations, states the same rule as §115(c) of the 1939 Code.

Section 346 of the 1954 Code, defining partial liquidation, is substantially expanded from §115(i) of the 1939 Code.

Section 302 of the 1954 Code, relating to the redemption of stock, is derived from §115(g) of the 1939 Code, but with substantial modifications.

Section 317 of the 1954 Code, defining redemption, is new.

BALLENGER v. UNITED STATES

301 F.2d 192 (4th Cir. 1962)

Before SOBELOFF, Chief Judge, and SOPER and BELL, Circuit Judges.

J. SPENCER BELL, Circuit Judge.

This is an appeal from a judgment of the District Court denying a refund of income taxes in the amount of $14,655.03 plus interest for the year 1954. The explanation given for the deficiency assessment was that the redemption of all of the outstanding preferred stock of the corporation, which was owned by the taxpayers, who are husband and wife, was essentially equivalent to a dividend and, was not, therefore, entitled to capital gains treatment under the provisions of §302 (b)(1) of the Internal Revenue Code of 1954.

A chronological statement of the pertinent facts is as follows: In 1949 the Ballenger Paving Company, a corporation, was organized to succeed a partnership of the same name and engage in the same business because one of the partners had died intestate leaving a widow and minor child. The court having jurisdiction

of the estate agreed to incorporation of the business as an alternative to liquidation. It was represented to the court that preferred stock would be issued to the estate and the widow and common stock to the remaining participants, but these plans were not carried out and the estate and the widow received both common and preferred stock, as did all parties concerned.

In the resulting corporate setup, taxpayers received 260 shares each of common and preferred, representing approximately 20% of the outstanding stock. The remaining 80% of the stock went to unrelated parties, including the estate and widow of the deceased partner.

On January 29, 1953, a resolution was adopted by the corporation calling for the liquidation of all of the stock both common and preferred held by parties other than taxpayers. These resolutions referred to the transaction as a partial liquidation. They made no reference to retirement of taxpayers' stock, either preferred or common.

By March 13, 1953, the retirement of all of the stock other than that held by taxpayers was accomplished by exchanging machinery and equipment owned by the corporation for the stock. Minutes of a meeting held on March 30, 1953, referred to the partial liquidation of the company as having been completed.

On August 20, 1954, taxpayers, being all of the stockholders and directors of the corporation, caused resolutions to be passed calling for the retirement of all of the outstanding preferred stock in accordance with the terms of the certificates. The only reason for this action expressed in the minutes was the desire to eliminate the 5% annual dividend called for by the terms of the preferred stock.

On September 11, 1954, the taxpayers received $27,300.00 from the corporation, that being the call price of 260 shares of preferred in accordance with the terms of the stock certificates.

There is no contention that taxpayers intended to liquidate the corporation or even contract the company's operations; on the contrary, the operations were steadily expanding. Corporate earned surplus on the date of redemption was far in excess of $27,300.00. Proportion of stock ownership and voting control of the corporation were not changed by the retirement. Dividends had never been declared or paid on the common stock during the history of the corporation.

Upon the foregoing facts the District Court found that the stock redemption was essentially equivalent to the distribution of a taxable dividend under §301 of the 1954 Act and, therefore, treated same as gross income to the taxpayers.

The taxpayers argue that the preferred stock which was being retired was originally issued for a valid business purpose: to prevent the liquidation of the business upon the death of one of its partners. They contend that when the stock of all the other stockholders was redeemed in 1953 the reasons for issuing preferred stock ceased to exist and this in itself constituted a valid business reason for redeeming their preferred stock. Indeed they say that the 1954 redemption of their stock was but the final step of a plan to liquidate all the preferred stock begun with the corporate resolutions of January 1953.

The Government denies that a valid corporate business purpose existed for redemption of taxpayers' stock at the time in question, but insists that even had a valid business purpose existed it would not in and of itself be sufficient to remove the transaction from the category of a dividend. It contends that the statute defines a dividend as any distribution by a corporation to stockholders paid out of accumulated or current earnings regardless of whether or not it was designated as such. The only exceptions recognized (with which we are here concerned) and thus given preferential treatment as capital gains under §302(b) of the 1954 Code are: (1) redemptions not essentially equivalent to a dividend, (2) redemptions that are substantially disproportionate, and (3) a complete redemption of all of a shareholder's stock. . . .

The 1954 Code substantially recast the law in this field. The distribution and reorganization provisions of the 1939 Code were sorted out and then rearranged into separate parts of subchapter C of Chapter 1 of subtitle A of the 1954 Code. Part I of subchapter C (§§301-318) contains rules for testing distributions by corporations other than liquidating distributions. Part II of subchapter C (§§331-346) covers liquidating distributions. Part III of subchapter C (§§351-367) covers corporate organizations and reorganizations with which we are not concerned in this case. In making the breakdown between Parts I and II of subchapter C an attempt was made to separate into their significant elements two general categories of cases dealing with corporate distributions which had been previously lumped together and treated as partial liquidations under §115(a) and §115(g)(1) of the 1939 Code. Thus under the 1954 Code, the category of cases wherein a distinction was drawn between stock redemptions which were to be given capital gains treatment rather than dividend treatment because they met certain tests when viewed from the standpoint of the stockholder's actions or motives are treated in Part I (§§301-318). On the other hand, the category of cases wherein a distinction was drawn between stock redemptions which were to be given capital gains treatment rather than dividend treatment because they met certain tests when viewed from the standpoint of the corporation's actions or motives are treated under Part II (§§331-346). In each category specific tests are provided which if met would entitle the distribution to capital gains treatment, but in each category there is also included a general negative test, e.g., that the distribution be "not essentially equivalent to a dividend" which if not met will deny the distribution capital gains treatment. See §302(b)(1) and §346(a)(2). The success of the effort to clarify the law in this area would have been unquestioned had not this vague negative test been included in the 1954 Code, thus re-injecting the confusion theretofore developed by the case law which has attempted to interpret the phrase "not essentially equivalent to a dividend."

When we attempt to apply the 1954 Code to a particular case, we must first determine whether or not the transaction meets the tests laid down in Part II, i.e., does it constitute a "partial liquidation" as therein defined? If not, we then turn to the specific tests set forth in subsections (b)(2), (b)(3) and (b)(4) of §302. If none of these specific tests apply then we must determine whether the distribution is "not essentially equivalent to a dividend" under subsection (b)(1) of §302. If it is not essentially equivalent to a dividend, it is entitled to capital gains treatment, no matter that it fails all of the more specific tests set forth in the Code.

Turning now to the instant case, the facts do not bring it within the provisions of Part II of the 1954 Act, §§331-346, nor indeed does the taxpayer so contend. By §331, capital gains treatment is accorded to property received by the taxpayer from a corporation in partial liquidation. The definition of a partial liquidation is found in §346. Subsection (a)(2), the only part of §346 relevant here, provides that a distribution of corporate property is treated as a partial liquidation if "the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year." The legislative history, the Treasury Regulations, and the applicable cases indicate that a primary factor to be considered in the definition of a partial liquidation, although not the sole factor, is whether there has been a contraction in the business of the corporation.[1] This test is not met in the present case, for there is no

[1] See Chommie, §346(a)(2): The Contraction Theory, 11 Tax L. Rev. 407 (1956); Murphy, Dividend Equivalence — The End of the Beginning, 10 Tax L. Rev. 213, 217-18 (1954). For a sharp criticism of reliance on corporate contraction as a factor in characterizing a redemption as a partial liquidation, see Bittker, The Taxation of Stock Redemptions and Partial Liquidations, 44 Cornell L.Q. 299, 307 n.22 (1959).

evidence of any lessening in the business being carried on by Ballenger Paving Company as a result of the redemption of the taxpayer's preferred stock. Indeed, the business was expanding. However, we need not pursue this issue further because neither does the taxpayer claim that his case falls within the partial liquidation provisions, nor was the case tried before the District Court on that theory.

If a redemption is not classified as a partial liquidation so as to be entitled to capital gains treatment via that route, then the provisions of §302 must be examined to see if relief for the taxpayer can be found there. Clearly, none of the "safe harbor" provisions of §302(b) apply. The facts of this case do not meet the precise, mathematical test for a substantially disproportionate redemption, which is applicable in any event only to voting stock, §302(b)(2); neither has there been a complete termination of the taxpayer's interest in the corporation, §302(b)(3); nor does this case involve the reorganization of a railroad corporation, §302(b)(4). Therefore, the taxpayer must, and does, rely upon §302(b)(1), providing for capital gains treatment "if the redemption is not essentially equivalent to a dividend." Since the statute gives no further aid in determining whether cash or other property distributed by a corporation in redemption of its stock is equivalent to a dividend, recourse must be had to the judicially developed rules. . . .

We now turn to the decisions setting forth the criteria which the Tax Court and the District Courts must apply to determine the applicability of §302(b)(1). When the cases are viewed solely from the shareholder's perspective, two lines of decisions appear. The first applies a strict "net effect" test.[2] Under this test, the court must hypothesize a situation where the corporation did not redeem any stock, but instead declared a dividend for the same amount. The court then must examine the situation after the dividend and compare it with the actual facts of the case when stock was redeemed, viewed always from the shareholders' vantage point. The redemption is equivalent to a dividend if the results from the hypothetical dividend and the actual stock redemption are essentially the same. As stated by Judge Medina, "We must ask whether, viewing the transaction as a whole, different results were produced by what was in form a partial liquidation from the results that would have been produced, under the circumstances, by a dividend." Northup v. United States, 240 F.2d 304, 306 (2d Cir. 1957). Under this approach, factors to be considered are whether the same shareholders would have received the identical payments had the redemption been a dividend, and whether the redemption altered the shareholders' control over the corporation and their respective rights to its future earnings. In evaluating the effect of the redemption on the future relationship between the parties, it also seems appropriate to consider whether the redemption is a part of a broader plan. Considering all these factors, it becomes apparent that every pro rata redemption will be equivalent to a dividend, for in no way can it result in any alteration in the relationship of the shareholders, both with respect to their share of the distribution in question and in respect to future control and profits.[3] However, the converse is not true, that every non pro rata redemption qualifies for §301(b)(1).

The second line of cases is not the direct antithesis of the first. All these cases adopt the "net effect" test, but add a further consideration — whether or not

[2] Kessner v. Commissioner, 248 F.2d 943 (3d Cir. 1957); Northup v. United States, 240 F.2d 304 (2d Cir. 1957); Kirschenbaum v. Commissioner, 155 F.2d 23 (2d Cir. 1946). The prior decisions in the Fourth Circuit appear to belong to this line of cases, although these opinions mention some factors which are more appropriate for consideration in the second line of cases. Commissioner v. Roberts, 203 F.2d 304 (4th Cir. 1953); Wall v. United States, 164 F.2d 462 (4th Cir. 1947).

[3] Treasury Regulation §1.302-2(b) provides: "All distributions in pro rata redemptions of a part of the stock of a corporation generally will be treated as distributions under §301 if the corporation has only one class of stock outstanding." Professor Bittker takes the position that §302(b)(1) can apply only to non pro rata redemptions. Bittker, The Taxation of Stock Redemptions and Partial Liquidations, 44 Cornell L.Q. 299, 322-25 (1959).

there are legitimate business purposes for the redemption.[4] An example of a redemption for a legitimate business purpose is the redemption of preferred stock to improve the corporation's credit position. To be suitable for consideration, a business purpose is not to be confined to one which furthers the successful conduct of the corporation; purposes stemming from the personal business affairs of the shareholders also warrant attention. An example of the latter is the redemption of stock as a part of a shareholder's complete withdrawal from the business. Of course, an acceptable business purpose can never be reducing income taxes, for the purpose of the statute is to prevent distribution of the earnings of the corporation to the shareholders at the lower, capital gains rates. Further not only is the legitimacy of the business objective to be achieved a factor to be considered, but also the purity of the motive for the redemption. Thus, it becomes relevant to consider whether the redemption plan initiated with the stockholders involved or with the corporate officers, whether in the preceding years the corporation had declared adequate dividends, and whether there were, in fact, corporate "earnings and profits," as defined by §316, to be distributed. These factors are relevant only to establish a tax avoidance motive. Under this approach, a pro rata redemption of stock can have a business justification sufficient to overcome its resemblance to a dividend under the "net effect" test. The result in any case would depend to a large extent on the weight to be given the business purposes, a matter on which those courts which have adopted this approach are far from agreement.

Although the cases following the strict "net effect" test do not permit proof as to business purpose, underlying the approach is the assumption that tax avoidance will always be one of the purposes of a redemption which places the parties in a position identical to that in which they would have been placed had a dividend been declared. And conversely, whenever the results of the redemption are significantly different, there must have been a legitimate business purpose, for otherwise there would be no reason for the stockholders to consent to unequal treatment. On the other hand, since it often happens that the corporation is closely held and the stockholders and corporate officers are the same people, courts following the second approach find it almost impossible to untangle the various purposes to say with any assurance that the redemption was justified by a legitimate business purpose. Recourse in such circumstances should be to the factors emphasizing the net effect of the transaction if the statute is to be reasonably applied. Viewed in this way, the only difference between the two lines of cases is that courts following the first will tax as a dividend any redemption for which tax avoidance is likely to be a motivating factor, while courts adhering to the second line of cases adopt a more flexible approach, by sometimes permitting a legitimate business purpose to prevail despite a concurrent tax avoidance motive.

Returning to the present case, an examination of the District Court's findings of fact indicates that, in concluding that the redemption was equivalent to a dividend, the District Court followed the approach adopted by the second line of decisions. However, it is not necessary for us to choose between the two lines of cases because, with either approach, the District Court must be upheld.

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[4] Heman v. Commissioner, 283 F.2d 227 (8th Cir. 1960); Earle v. Woodlaw, 245 F.2d 119 (9th Cir. 1957); United States v. Fewell, 255 F.2d 496 (5th Cir. 1958); Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954); Jones v. Griffin, 216 F.2d 885 (10th Cir. 1954). The opinions in the Sixth Circuit do not disclose which line of decisions the court follows, but the results under the facts of their cases would no doubt be the same under either test. Bell v. Commissioner, 248 F.2d 947 (6th Cir. 1957); Woodworth v. Commissioner, 218 F.2d 719 (6th Cir. 1955). Flanagan v. Helvering, 73 App. D.C. 46, 116 F.2d 937 (1940), often cited as the progenitor of the strict "net effect" test, actually mentions factors more appropriate to the second approach. The Tax Court also appears to follow the second line of decisions. Decker, 32 T.C. 326 (1959); Stolz, 30 T.C. 530 (1958), aff'd Stolz v. Commissioner, 267 F.2d 482 (5th Cir. 1959).

We are dealing here with a sole stockholder who has caused the corporation to pay him $27,300.00 out of its earned surplus* in redemption of all of his preferred stock. The redemption is pro rata. It is true that the taxpayer's wife holds one share in the corporation. This is too small to upset the pro rata characterization of the distribution, and secondly, under the attribution of ownership rules of §318, made applicable to §302, the wife's ownership is constructively her husband's. If we apply a strict "net effect" test to these facts, the redemption must not be given capital gains treatment because a pro rata redemption, at least when not a partial liquidation as defined by §346, will always be essentially equivalent to a dividend.

The result is the same if we follow the second line of cases and inquire whether there is a legitimate business purpose which can outweigh the factors indicating dividend treatment. The taxpayer claims that the preferred stock was originally issued for a valid business purpose, to protect the interests of the widow and child of the deceased former partner according to the directions of the North Carolina state court having supervisory jurisdiction over the estate. The taxpayer further claims that it was a part of the original plan to redeem the preferred stock as soon as its usefulness ceased, as was the case once the interests in the corporation held by the widow and child and other outside stockholders had been terminated. However, we cannot understand how a valid reason for the issuance of preferred stock can, once its purposes have been served, be converted into a reason for its redemption. Even if it had been originally understood that the preferred stock would eventually be redeemed, such a fact is not, without more, a legitimate business justification.

The taxpayer, however, assigns additional reasons for the redemption. It was thought undesirable from a corporate planning standpoint to burden the corporation with the obligation to pay dividends on the preferred stock which, if not paid, were cumulative. In addition, it is contended, the bonding company considers cumulative preferred stock objectionable. Finally, the taxpayer argues, financing by means of preferred stock is not as satisfactory from a business standpoint as financing by loans, both because interest payments are made a deductible expense by §163 while dividend payments are not, and because the prevailing interest rate was lower than the 5% dividend on the preferred stock. Nevertheless, these objections could be remedied without at the same time effecting a distribution of corporate earnings at capital gains rates. The taxpayer could as readily have caused the preferred stock to be exchanged for common stock or have amended the corporate charter or by-laws to delete the objectionable features of the preferred stock. In the case of a pro rata redemption of stock especially, any business justification must be indeed compelling to overcome the "net effect" test which points to a tax avoidance scheme.

For these reasons, the judgment below is affirmed.

NOTE

1. *"Not essentially equivalent to a dividend."* The "two lines of cases" which the court summarizes derive from §115(g) of the 1939 Code, providing that a distribution in redemption or cancellation of stock (to the extent covered by earnings and profits) was to be treated as a taxable dividend if it occurred "at such time and in such manner as to make the distribution and cancellation in whole or in part essentially equivalent to the distri-

* Although the corporation's earned surplus is often used as a loose measure of its earnings and profits, the amounts may be very different (e.g., a non-taxable stock dividend reduces earned surplus, but leaves earnings and profits intact). In referring to the corporation's earned surplus, the court implicitly assumed that the earnings and profits were likewise in excess of $27,300. — Ed.

bution of a taxable dividend." In separating partial liquidations under §346 from other stock redemptions under §302, the 1954 Code was described by the Senate Finance Committee Report (p. 49) as having this effect:

> Those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in [§302, §303, and §304]. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of a partial liquidation.

With the implication that a redemption can satisfy §302(b) *only* if it is non pro rata, compare Sorem v. Commissioner, 40 T.C. 25 (1963):

> The evidentiary criteria useful in determining under [§302(b)(1)] the dividend or nondividend character of a particular distribution which fails to qualify as a sale or exchange of stock under one of the three "automatic" tests contained in §302(b)(2), (3), or (4), remain substantially the same as those which were found helpful by the courts in determining dividend equivalence under [1939 Code, §115(g)].

2. *Constructive ownership of stock under §302(b).* Since both §302(b)(2) and §302(b)(3) explicitly refer to the amount of stock "owned" by the shareholder, the constructive ownership rules of §302(c) are applicable, with the result that many redemptions by closely held corporations will have more trouble in meeting the standards of "substantially disproportionate" under §302(b)(2) or "complete" under §302(b)(3) than one might think at first glance. If a redemption fails to qualify under these subsections because it is neither "complete" nor "substantially disproportionate" when stock owned constructively by the taxpayer is taken into account, can §302(b)(1) be used as an alternative route to capital gain treatment? Note that §318 states that the constructive ownership rules are to be employed only when "expressly made applicable," that §302(c)(1) states that they shall be applied "in determining the ownership of stock" under §302, but that §302(b)(1) does not explicitly refer to ownership of stock, as do §§302(b)(2) and 302(b)(3). Despite this, there is authority for taking the constructive ownership rules into account in applying §302(b)(1). Lewis v. Commissioner, 35 T.C. 71 (1960); see also the *Ballenger* case, supra. Would it also be proper, in applying §302(b)(1), to take into account evidence of a shareholder's estrangement from, or independence of, the persons whose shares would be imputed to him by §302(c)? See Squier's Estate v. Commissioner, 35 T.C. 950 (1961) ("sharp cleavage" and other facts outweigh attribution rules).

Another escape from the constructive ownership rules is provided by §302(c)(2). If a redemption would otherwise qualify under §302(b)(3) as a complete redemption of all of the shareholder's stock, he can avoid an attribution of stock from other members of his family (but not attribution from partnerships, trusts, corporations, etc., in which he has an interest), provided (a) for ten years after the redemption he does not acquire any "interest" in the corporation (as defined), and (b) for ten years before the redemption he did not engage in certain tax avoidance transactions (primarily transfers of stock to or from related persons). Because the taxpayer who relies on this waiver of the family attribution rules is put on good behavior for a ten-year period, he must agree to notify the Treasury if he acquires a forbidden interest in the corporation, and the statute of limitations on the year of the redemption is appropriately suspended. See Van Keppel v. United States, 321 F.2d 717 (9th Cir. 1963).

3. *The meaning of "redemption."* Section 317(b) defines "redemption." By specifically including a transaction in which reacquired stock is held in the corporate treasury, it clears up a problem under §115(g) of the 1939 Code, which spoke of a "cancellation" or "redemption" of stock. The Court of Appeals for the Second Circuit expressed the view that treasury shares have not been canceled or redeemed. Kirschenbaum v. Commissioner, 155 F.2d 23 (2d Cir. 1946) cert. denied, 329 U.S. 726. The Court of Appeals for the Seventh Circuit agreed, Commissioner v. Snite, 177 F.2d 819 (7th Cir. 1949), but the Fourth Circuit was contra:

> If it should be held that taxpayers can avoid the terms of the statute by the simple device of selling their stock to the corporation and having it held as treasury stock, the purpose of the statute to prevent the evasion of taxes upon corporate dividends would be completely frustrated. [Wall v. United States, 164 F.2d 462, 465 (4th Cir. 1947).]

An intermediate position, treating treasury shares as canceled or redeemed where there was no intention to reissue them, was apparently approved in Boyle v. Commissioner, 187 F.2d 557 (3d Cir. 1951).

Section 317(b)'s definition of redemption is clearly applicable to that term as used in §302. But does it also apply to "redemption" as used in §346?

4. *Redemptions to pay death taxes.* Section 303, relating to distributions in redemption of stock to pay death taxes and funeral and administration expenses, is a liberalized version of a provision that first entered the Code in 1950, as §115(g)(3) of the 1939 Code. If the stock of a single corporation constitutes more than 35 per cent of the value of a decedent's gross estate or more than 50 per cent of his taxable estate, a redemption of the stock up to the amount of the death taxes and funeral and administration expenses will be a capital gain or loss transaction. The stock of two or more corporations can also qualify under certain circumstances. Of course, not every redemption of an estate's stock would be a taxable dividend under §302 even in the absence of §303; recourse to the latter section will be necessary only if without it the distribution would be a dividend. For an estimate of the need for a provision of this type, see Harriss, Estate Taxes and the Family Owned Business, 38 Calif. L. Rev. 117 (1950). See also Lanahan, Redemptions to Pay Death Taxes: Redemptions Through the Use of Related Corporations (Sections 303, 304), 15 N.Y.U. Inst. on Fed. Taxation 493 (1957).

5. *Redemptions by affiliated corporations.* Section 304 is derived from §115(g)(2) of the 1939 Code, enacted in 1950 to overrule Wanamaker Trust v. Commissioner, 11 T.C. 365 (1948), aff'd per curiam, 178 F.2d 10 (3d Cir. 1949), which held that §115(g) did not apply to an acquisition by a wholly owned subsidiary of stock in the parent corporation; see also Commissioner v. Pope, 239 F.2d 881 (1st Cir. 1957). By virtue of changes in 1954, this section now covers redemptions by a corporation of the stock of a wide range of related corporations, as well as parent-subsidiary redemptions. Transactions of this type must now be tested by the rules of §302; they can no longer claim the automatic immunity conferred by the *Wanamaker Trust* and *Pope* cases. See Lanahan, Redemptions Through Use of Related Corporations, 18 N.Y.U. Inst. on Fed. Taxation 741 (1960); Diamond, Brother-Sister Corporations — Sale of Stock or Other Assets, and Other Problems, 1959 So. Calif. Tax Inst. 109.

6. *The case of the disappearing basis.* When a taxpayer receives an ordinary dividend, the basis of his shares is unaffected by the receipt, and gain or loss on a subsequent disposition of the shares is calculated accordingly. But if he gets a §302(d) dividend, he no longer has the shares for a later sale or other disposition. What happens to his basis? If it is lost, a §302(d) distribution is not the equivalent of an ordinary dividend; it is worse than one. See Regs. §1.302-2(c), stating that when a redemption of stock is treated as a dividend, "proper adjustment of the basis of the remaining stock will be made with respect to the stock redeemed," and note Examples (1)-(3). Before the promulgation of these regulations, the fate of the redeemed stock's basis was veiled in mystery. See Brodsky and Pincus, The Case of the Reappearing Basis, 34 Taxes 675 (1956).

7. *Redemption of stock vs. retirement of bonds.* Sections 302 and 346 both speak of a redemption of "stock." The retirement of bonds and other evidences of indebtedness is ordinarily a capital gain or loss transaction by virtue of §1232, and there is no counterpart of §302 to treat the retirement of such creditor instruments as a distribution of earnings and profits. Once more (see p. 641 supra) we find the Internal Revenue Code smiling on the issue of debt instruments instead of stock by the newly organized corporation; §1232 is a channel through which corporate profits may be withdrawn without being classified and taxed as dividends. But the same criteria that turn ostensible bonds or debentures into stock so as to deny the deduction for so-called interest may also require the "bonds" to be treated as "stock" under §302. Supra page 642; Schlesinger, "Thin" Incorporations: Income Tax Advantages and Pitfalls, 61 Harv. L. Rev. 50, 78-86 (1947).

8. *Redemption of §306 stock.* Section 306, dealing with the redemption or sale of certain classes of stock (primarily preferred stock issued as a stock dividend), is examined infra page 697.

9. *References.* Cohen, Redemptions of Stock Under the Internal Revenue Code of 1954, 103 U. of Pa. L. Rev. 739 (1955); Bittker, Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954, 9 Stan. L. Rev. 13 (1956); Winton and Hoffman, A Case Study of Stock Redemptions Under Sections 302 and 318 of the New Code, 10 Tax L. Rev. 363 (1955).

TELEVISION INDUSTRIES, INC. v. COMMISSIONER

284 F.2d 322 (2d Cir. 1960)

Before CLARK, MAGRUDER and FRIENDLY, Circuit Judges.

FRIENDLY, Circuit Judge.

This is a petition by a taxpayer to review a decision of the Tax Court, 32 T.C. 1297, finding petitioner liable as transferee for a deficiency of $77,199.53, together with interest, in the income tax of National Phoenix Industries, Inc., hereafter "Phoenix." This finding stems from a conclusion that $1,026,285 received by Phoenix from Nedick's, Inc. on November 15, 1951, and not reported as income, was taxable to Phoenix as a dividend under §115(g) of the Internal Revenue Code of 1939. The facts, which are not disputed, are set forth at length in the opinion of the Tax Court. We shall state only such as we deem essential for understanding the problem presented.

In May, 1951, 900 shares of the stock of Nedick's, Inc. were owned by the Estate of Maurice Wertheim and his associates, hereafter "the Wertheim interests." These shares constituted 90% of the outstanding stock; the other 100 shares were owned by employees from whom Nedick's was entitled to purchase. At a meeting of the board of directors of Phoenix on May 14, 1951, the chairman narrated negotiations he had been conducting for the purchase of the stock of the Wertheim interests for $3,600,000, payable $200,000 on signing the contract, $500,000 60 days thereafter, and $2,900,000 six months later. In discussing the financing of the proposed purchase, he stated his opinion "that at least $1,000,000 would be available in Nedick's, Inc. itself to be applied toward the purchase price." He also expressed the view that "Nedick's, Inc., had great opportunity for improvement and expansion. . . ."

Pursuant to authority given by its directors, Phoenix entered into a purchase agreement with the Wertheim interests on May 21, 1951, substantially as indicated by the chairman at the directors' meeting. The first two installments of the purchase price were paid. On August 2, 1951, Nedick's purchased 50 shares of stock owned by its then president, pursuant to its option; the remaining 50 shares were purchased, also pursuant to option, on December 14, 1951.

On November 7, the chairman of Phoenix was authorized by its directors to obtain a clearance loan of $1,000,000 from a bank for use in making the final payment. The minutes recite that the chairman "pointed out that Nedick's, Inc. had cash available which, if used by it to purchase a portion of the shares so acquired by the Corporation, would thereby be made available to the Corporation to repay such loan." On November 15, Phoenix borrowed $1,000,000. It paid the final installment of the purchase price, which had been reduced to $2,845,000, with these funds and its own, received delivery of the 900 shares from the escrow agent, and immediately offered to sell Nedick's, Inc. 260 shares for $1,026,285, this being the purchase price of these shares plus an appropriate proportion of the expenses of the entire purchase. Nedick's forthwith accepted Phoenix's offer and paid for the 260 shares. Phoenix used $1,000,000 of the proceeds to pay off the clearance loan.

In its 1951 Federal income tax return, Phoenix reported the sale of the 260 shares to Nedick's as having been without gain or loss. The Commissioner asserted that the payment by Nedick's was a dividend to Phoenix under §115(g) of the Internal Revenue Code of 1939, which provides that

> If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.*

The Tax Court has upheld the Commissioner's determination.

If attention may properly be limited to the transaction between Phoenix and Nedick's on November 15, 1951, the Commissioner was quite clearly warranted in concluding that the payment was within the statute, even without the gloss provided by Treasury Regulations 118, §39.115(g)-1(a)(2):

> . . . A cancellation or redemption by a corporation of a portion of its stock pro rata among all the shareholders will generally be considered as effecting a distribution essentially equivalent to a dividend distribution to the extent of the earnings and profits accumulated after February 28, 1913.

Phoenix was the owner of all the outstanding stock of Nedick's, save for the 50 shares which Nedick's had under option and acquired only a month thereafter; hence the payment was in effect pro rata. It had "the same effect" as a dividend of the same amount, see Northup v. United States, 2 Cir., 1957, 240 F.2d 304, 306 . . . There was no evidence that the payment was incident to a contraction of Nedick's business. It is immaterial that the 260 shares were held for some time in Nedick's treasury. Wilson v. United States, 2 Cir., 1958, 257 F.2d 534, certiorari denied 358 U.S. 893.

Petitioner contends that this is too much a key-hole view. It says that the transaction had precisely the same effect as if the Wertheim interests had sold 260 shares to Nedick's for $1,026,285 and had sold petitioner 640 shares for $2,518,715, and that if the transaction had been cast in that form, the payment to the Wertheim interests would not have been taxable under §115(g), Zenz v. Quinlivan, 6 Cir., 1954, 213 F.2d 914, now followed by the Commissioner, Rev. Ruling 54-458, 1954-2 C.B. 167, and there would have been no payment to Phoenix to be taxed. We find little persuasiveness in the argument stated in that form. The Commissioner is justified in determining the tax effect of transactions on the basis in which taxpayers have molded them, Gray v. Powell, 1941, 314 U.S. 402, 414; Interlochen Co. v. C.I.R., 4 Cir., 1956, 232 F.2d 873, 877, although he may not always be required to do so, Higgins v. Smith, 1940, 308 U.S. 473, 477. It would be quite intolerable to pyramid the existing complexities of tax law by a rule that the tax shall be that resulting from the form of transaction taxpayers have chosen or from any other form they might have chosen, whichever is less.

Petitioner is on stronger ground, although not strong enough, when it urges that, taking the transaction as it was, the Commissioner was still not warranted in finding that the distribution was "essentially equivalent to the distribution of a taxable dividend." Petitioner says that Phoenix started on November 15, 1951 owning no stock in Nedick's and ended owning 640 shares which had cost it $2,518,715 plus expenses, and that to seize on Phoenix's momentary ownership of 260 shares is to atomize the transaction and to put form above substance. The

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* Section 115(g), 1939 Code, was the predecessor of §302 (redemptions) and §331(a)(2) (partial liquidations) of the 1954 Code, both discussed in the *Ballenger* case, supra page 652. — Ed.

Commissioner responds that it is the taxpayer that is atomizing the transaction by seeking to obliterate the significant step wherein a corporation's earnings and profits passed into its stockholders' hands. The Government relies heavily upon the opinion of Judge Stewart, as he then was, in Woodworth v. C.I.R., 6 Cir., 1955, 218 F.2d 719, 724; taxpayer would distinguish that decision on the basis that two years intervened between the acquisition of the stock by the purchasers and its sale to the company and there was no evidence of an antecedent plan. We agree that the present case differs in this respect from Woodworth and also from Wall v. United States, 4 Cir., 1947, 164 F.2d 462, and Lowenthal v. C.I.R., 7 Cir., 1948, 169 F.2d 694, on which the Commissioner relies and which taxpayer seeks to distinguish on like grounds. However, it is not enough that there be a difference; the difference must be a significant one, and here is where taxpayer's argument fails. For we are unable to see why the Commissioner may not lawfully determine that a sole stockholder's removal of earnings and profits from a corporation, which it intends to improve and expand, was "essentially equivalent to the distribution of a taxable dividend" under §115(g), rather than a "partial liquidation" taxable on a capital gain basis under §115(c), even though the stockholder had just acquired the stock and had planned from the outset to do precisely what it did. See Ferro v. C.I.R., 3 Cir., 1957, 242 F.2d 838; and the full discussion of the history and the authorities in 1 Mertens, Law of Federal Income Taxation, §9.100. Taxpayer relies on Fox v. Harrison, 7 Cir., 1944, 145 F.2d 521; Holsey v. C.I.R., 3 Cir., 1958, 258 F.2d 865, acquiesced in Rev. Ruling 58-614, 1958-2 C.B. 920; and Niederkrome v. C.I.R., 9 Cir., 1958, 266 F.2d 238, certiorari denied sub nom. Royce v. C.I.R., 1959, 359 U.S. 945. Fox v. Harrison is distinguishable as resting on a finding by the trial court that the purchaser of the stock "was acquiring said stock on behalf of the corporation and as a temporary expedient" [145 F.2d 522]; here there was no finding that Phoenix was acquiring the stock on Nedick's behalf. The two later decisions, Holsey v. C.I.R. being that of a divided court, relate to payments to stockholders other than the taxpayer sought to be taxed. Cases such as C.I.R. v. Ashland Oil and Refining Co., 6 Cir., 1938, 99 F.2d 588, certiorari denied, 1939, 306 U.S. 661, and Georgia-Pacific Corp. v. United States, 5 Cir., 1959, 264 F.2d 161, also relied on by taxpayer, are not controlling as to problems under §115(g).

Judgment affirmed.

NOTE

1. *Bootstrap purchases — on a shoestring.* Redemptions are often utilized to effect "shoestring" purchases of closely held corporations. Thus: A owns all the stock of a corporation; he wishes to sell out to B, but B cannot finance the entire purchase with his own funds. The corporation's assets include a substantial amount of cash and marketable securities. A sells part of the stock to B, and then the corporation redeems the rest of A's stock. Note that if part of A's stock had been redeemed while he was the sole stockholder, the redemption would probably have been essentially quivalent to a dividend, under either the 1939 or the 1954 Code. Despite this fact, it was held under the 1939 Code that a redemption following a sale, as described above, is a sale by A of his stock, not a dividend. Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); Edenfield v. Commissioner 19 T.C. 13 (1952). After losing these cases, the Internal Revenue Service acquiesced, though announcing that such transactions "will be closely scrutinized to determine whether the selling stockholder 'ceases to be interested in the affairs of the corporation' immediately after redemption." Rev. Rul. 54-458, 1954-2 C.B. 167. The following year, the Service announced that it would apply the *Zenz* case to transactions governed by the 1954 Code, so that the redemption of A's stock will qualify under §302(b)(3) as a sale. Rev. Rul. 55 745, 1955-2 C.B. 223. What if A remains interested in the corporation (e.g., performs serv-

ices under a profit-sharing agreement: or is to receive a percentage of future profits for his shares)?

What about B? When the Service announced in Rev. Rul. 54-450, supra, that it would follow the *Zenz* case as to A, it went on to say that such redemptions "will . . . be examined to determine whether any payment by the corporation for stock has the effect of a dividend to the stockholders who remain interested in the corporation," citing Wall v. United States, 164 F.2d 462 (4th Cir. 1947). In the *Wall* case, however, B agreed to buy all of the stock, and then caused the corporation to pay for some of it. When the buyer commits himself to purchase only part of the stock, the corporation being obligated to buy the rest, he has been successful in avoiding a taxable dividend. See the *Fox*, *Neiderkrome*, and *Holsey* cases, cited by the court. The Internal Revenue Service, after losing a series of such cases, announced in 1958:

> In the future, the Service will not treat the purchase by a corporation of one shareholder's stock as a dividend to the remaining shareholders merely because their percentage interests in the corporation are increased. On the other hand, if the stock is in reality purchased by a remaining shareholder and paid for by the corporation, then, regardless of the form of the transaction, the payment will be considered a dividend to the shareholder who made the purchase. [Rev. Rul. 58-614, 1958-2 C.B. 920.]

Do these developments leave the possibility of a dividend tax in situations like that in *Television Industries* as no more than a trap for the unwary? Note that the purchase by Nedick of the 50 shares owned by its president was apparently not claimed by the United States to constitute a dividend to Television Industries, Inc.

2. *Impact of dividends received deduction.* When a redemption of stock owned by a corporation is taxed as a dividend, the blow is softened by the 85 per cent dividends received deduction of §243. Even so, in *Television Industries*, the taxpayer argued that the transaction was a sale of the stock, because the amount realized did not exceed the basis of the stock, so that there was no gain. If there had been a substantial gain (e.g., if the shares had been acquired many years earlier at a low cost), however, a tax at the capital gain rate on the difference between cost and amount received might exceed the tax burden of having the redemption treated as a dividend. This explains why the taxpayer in Pacific Vegetable Oil Corp. v. Commissioner, 251 F.2d 682 (9th Cir. 1957), argued that a redemption was substantially equivalent to a dividend, while the government asserted that it was a bona fide sale of the stock.

3. *References.* Lange, Bootstrap Financing: The Redemption Technique, 18 Tax L. Rev. 323 (1963); Redlich, The Sale of a Closely-Held Business, 9 id. 354 (1954).

REV. RUL. 60-322

1960-2 C.B. 118

Advice has been requested relative to the tax consequences of a proposed distribution by a corporation of cash, realized from the sale of United States Government bonds and excess inventories, to its stockholders under the circumstances described below.

M corporation has 3,800 shares of common stock, par value of 10x dollars per share, of which 200 shares are held in the treasury. The balance sheet indicates accumulated earnings of 1,500x dollars.

The corporation was engaged in the business of buying raw skins and tanning and selling the leather to a certain segment of the leather trade. It showed consistent profits until two years ago when the demand therefor suffered a serious, if not a permanent, decline. In an effort to revitalize the business, the corporation changed over to buying raw skins of another kind and tanning and selling the leather to another segment of the leather trade. However, the situation did not improve, with the result that continuing losses were incurred and a large inventory of 5,000x dollars was accumulated.

Early in the year under consideration, M corporation determined that further purchases should be curtailed and inventories liquidated. Pursuant to this policy, the inventory was reduced to 3,000x dollars. In doing so, the corporation had sustained substantial operating losses. However, in view of the depressed state of the market and the grim future prospects, the process of liquidating its inventory is expected to be continued and the operations will be carried on at a modified basis with purchases kept at a minimum. In this manner, it is felt that the operating losses can be minimized and if the business decline continues, then a complete liquidation will eventually be voted by the stockholders. Accordingly, the M corporation proposes to redeem a portion of its stock with cash from the sale of United States Series G bonds and from the proceeds of the inventories being liquidated in the ordinary course of business.

[Text of §331(a)(2) and §346(a)(2), relating to partial liquidations, is omitted.]

Where a corporation has earnings available, in order for the distribution of assets by it to its shareholders to be treated as a partial liquidation, the distribution must result from a genuine contraction of the business of the corporation. See Imler v. Commissioner, 11 T.C. 836, acquiescence, C.B. 1949-1, 1. See also Rev. Rul. 59-240, C.B. 1959-2, 112, and Rev. Rul. 60-232, 1960-2 C.B. 115. In the instant case, the earnings and profits of prior years were retained in the corporation and resulted in building up a large inventory and investment of funds in Government bonds.

Under the foregoing set of facts, it is held that neither the sale of investments nor the sale of a large part of the inventory in the ordinary course of business constitutes a genuine contraction of the business of the corporation. Accordingly, the proposed distribution of cash for the portion of the stock of M corporation to be redeemed will not constitute a distribution in partial liquidation within the purview of section 346 of the code. The provisions of section 301 will apply to this distribution and, accordingly, the distribution will be taxed as a dividend to the extent provided in section 316.

NOTE

1. *Contraction by fire.* When tax lawyers get together to discuss the most "genuine contraction of the business" they have ever encountered, they always come back to *Imler*, cited in the foregoing ruling:

> The principal building owned by the company had been damaged by fire in 1941. When the company undertook to repair the building it was found that, because of war conditions, the shortage of building materials, and high costs, it was advisable to abandon 2 damaged floors and reduce the 7-story building to one of 5 stories. The consequence was that the company found its facilities inadequate to carry on the retinning and soldering operations formerly engaged in. Moreover, these operations had proven unprofitable in recent experience because of war conditions and shortage of necessary materials. For these reasons the company discontinued the retinning and soldering operations. This reduction in operations likewise reduced the amount of capital necessary for carrying on the business activities of the company. This was a bona fide contraction of business operations and consequent reduction in capital used. The company thus had a real and legitimate purpose for reducing its outstanding capital stock.
>
> The motives of the corporation were all related to the above business purpose and were, therefore, legitimate and properly conceived. If the excess of insurance proceeds be set to one side, the surplus of the company had remained almost constant for 10 years. The company had followed a conservative dividend policy throughout its history and had not paid a dividend since 1934. The original issuance of the stock had occurred many years before and there was no connection between the issuance and the redemption of the same. There was no special circumstance or condition re-

lating to the distribution excepting the fact that the company had in its hands the excess insurance proceeds which formed the basis of the distribution. We are convinced that, except for the fire and the excess insurance proceeds, there would have been no distribution. [11 T.C. 836.]

2. *Distribution of working capital.* The Service has ruled that on a genuine corporate contraction, a distribution in partial liquidation may include not only the net proceeds from a sale of the operating assets but also an amount equal to the working capital attributable to the terminated business activity. Rev. Rul. 60-232, 1960-2 C.B. 115. The ruling continued:

> In determining the amount of working capital reasonably attributable to the operation of the business activity terminated, the Service will take into consideration all pertinent factors. The amount of working capital actually used in the business activity just prior to its termination will be the primary consideration. However, an unusual or abnormal increase just prior to the distribution in the size of inventories, work in process, accounts receivable, cash accounts, or other items, may indicate an attempt to secure partial liquidation treatment of a distribution involving an amount of working capital in excess of that normally required in the operation of the business terminated. The amount of cash and other liquid assets is never in itself an indication of the amount of working capital attributable to a business activity since a corporation may retain liquid assets in excess of the needs of its business. Because the determination of the amount of working capital attributable to any business activity is a factual matter, a specific determination on this point will be made by the Service only after an examination of the income tax return of the corporation making the distribution in partial liquidation.

3. *Termination of a business.* In an effort to lend a degree of certainty to the concept of "corporate contraction," in 1954 Congress enacted §346(b), describing a special type of contraction that qualifies as a partial liquidation. To meet the requirements of §346(b), the corporation must distribute the assets, or the proceeds, of a business which was actively conducted for the five-year period immediately preceding the distribution, and immediately after the distribution it must continue to be engaged in a second trade or business with a similar five-year history. The concepts used by §346(b), and some of its problems, overlap those of §355 (relating to so-called divisive reorganizations) and are better examined in conjunction with §355, infra pages 713 et seq.

4. *References.* Chommie, Section 346(a)(2): The Contraction Theory, 11 Tax L. Rev. 407 (1956); Brodsky, Partial Liquidation: Definition of Partial Liquidation and Rules for Determining Termination of a Business, 15 N.Y.U. Inst. on Fed. Taxation 539 (1957); Schoettle, Section 346 of the Internal Revenue Code: A Legislative Enigma, 109 U. of Pa. L. Rev. 944 (1961).

SECTION G. DISTRIBUTIONS OF CASH AND PROPERTY — IMPACT ON THE CORPORATION

1. *Tax Effect of the Distribution Itself: The General Utilities Doctrine, §311, and §336*

Section 311 of the 1954 Code, relating to the effect of a distribution of property on the income of the distributing corporation, has no counterpart in the 1939 Code.

Section 336 of the 1954 Code, relating to the effect of a distribution in partial or complete liquidation on the distributing corporation, is also new, but it is derived from Regs. 118, §39.22(a)-20.

In General Utilities & Operating Co. v. Helvering, 296 F.2d 200, the government argued that a distribution by the taxpayer corporation of stock of another

corporation, having a cost basis of about $2000 and a fair market value of about $1 million, generated taxable income at the corporate level. To support this contention before the Board of Tax Appeals, the government relied on the theory that the corporation had in effect declared a dividend of $1 million and satisfied the indebtedness thus created by distributing the securities. There is authority for treating appreciation or depreciation as realized by a corporation on a distribution if the dividend resolution creates a debt to the shareholders. Bacon-McMillan Veneer Co. v. Commissioner, 20 B.T.A. 556 (1930) (gain); Callanan Road Improvement Co. v. Commissioner, 12 B.T.A. 1109 (1928) (loss). But these cases were held by the Board of Tax Appeals to be inapplicable to the General Utilities & Operating Company distribution because the dividend resolution was interpreted as declaring a dividend of property only, rather than a dividend of a specified amount of money. Before the Court of Appeals, the government added a second argument: that a sale of the stock that occurred immediately after the distribution should be attributed to the corporation, although made in form by the shareholders, under principles that are examined infra pages 675 et seq. On this point, the Court of Appeals agreed with the Treasury. The Supreme Court granted certiorari. In its Supreme Court brief, the Treasury added a third argument:

> It is not open to doubt that the phrase "sale or other disposition" connotes a transfer by which a gain is realized or a loss is sustained, and one of the principal reasons for rejecting the suggestion that a dividend distribution is a "disposition" has been the circumstance that the stockholders pay no consideration to the corporation, and hence there is no actual receipt of gain in a tangible form. We think that this reasoning misses the point, for in making it available to its own stockholders the corporation is realizing the appreciation, and nothing more is necessary. It is our view that the addition to surplus on account of the increased value and the distribution of this increased value in satisfaction of the company's general liability to its stockholders, are the evidence that the gain has been realized, for it is incomprehensible how a corporation can distribute to its stockholders something which it has not itself received. Petitioner had an earned surplus equivalent to the value of the stock distributed. . . . It is clear that petitioner used the increased value for a corporate purpose, and was thereby enabled to pay its stockholders $1,071,426.25. Thus was petitioner serving the principal end for which it was organized — to earn profits which it could distribute to its stockholders — and we submit that in so justifying the hopes of its organizers this economic entity, called a corporation, truly derived an economic gain. [Respondent's brief 17-19, 25.]

It should be noted that if this third argument were accepted, the appreciation in the value of the distributed property would be taxed to the corporation even if it were conceded that the sale of the property was made by the stockholders and not by the corporation. Indeed, a sale of the distributed property would not be necessary; the distribution itself, it was contended by the government, was a realization of income by the corporation.

The Supreme Court reversed, with a brief opinion agreeing with the Board of Tax Appeals that the distributed assets were not used to discharge a corporate debt. As to the second point, the Court held that it should have been raised in the Board of Tax Appeals and could not be belatedly argued in the appellate court; the government's third argument was not mentioned. Although the commentators could not agree on whether the theory of realization-by-distribution was rejected on the merits by implication or passed over because advanced too late in the proceeding, the former explanation of its fate became popular with the courts. See, however, R. D. Merrill Co. v. Commissioner, 4 T.C. 955, 961 (1945). Even if the issue was left open by the *General Utilities* case, however, its scope was limited to distributions of property by the going concern; the Regulations

had long provided that a corporation does not realize gain or loss on distributing property in partial or complete liquidation. Regs. 118, §39.22(a)-20 (1939 Code).

With the enactment of the 1954 Code, statutory guidance was provided in this area for the first time:

1. *Non-liquidating distributions: §311.* Section 311 provides that no gain or loss shall be recognized by a corporation on a distribution of property, except for a distribution of "LIFO inventory" (see §472), or of property whose adjusted basis is less than the liability (if any) to which it is subject or which is assumed by the shareholder in connection with the distribution. Why is income to be recognized on these distributions? Do these exceptions to §311(a) require the corporation to recognize income on unrealized appreciation in the value of property, see Eisner v. Macomber, supra page 56?

What is the effect of §311(a) on the cases, supra page 666, holding that when a dividend resolution creates a debt to the stockholders, the satisfaction of the debt with appreciated property produces income?

2. *Distributions in partial or complete liquidation: §336.* Section 336 provides that no gain or loss shall be recognized by a corporation on a distribution of property in partial or complete liquidation. This statutory rule confirms the position taken in the pre-1954 Regulations, supra, but provides that the gain is not to be recognized rather than that it is not "realized" by the corporation. Why is §336 not subject to the exceptions for LIFO inventory and excessively mortgaged property that are found in §311?

3. *Exceptions for installment obligations, §1245, and §1250.* Both §311 and §336 are explicitly subordinated to the rules requiring gain to be recognized on a disposition of installment obligations and, although one must look outside of §§311 and 336 to discover the fact, they are also subordinate to the recapture of depreciation provided by §1245 and §1250.

4. *Earnings and profits.* The tax effect at the shareholder level of a distribution of appreciated property may depend on the amount of corporate earnings and profits. If the distribution itself produces taxable income (because it comes within one of the exceptions to §311 or §336), it will also generate earnings and profits; conversely, if the distribution does not produce income, it will ordinarily not create earnings and profits. See §312(f) (second sentence). In two special cases, however, a distribution increases earnings and profits even though it does not produce taxable income: §312(b) (distributions of appreciated "inventory assets," as defined); and §312(j) (distributions when corporate property is mortgaged in excess of its basis under a loan made, guaranteed, or insured by United States, infra p. 688).

If the earnings and profits of the corporation (after taking into account the adjustments of the preceding paragraph) are less than the fair market value of the distributed property, the individual shareholders treat the fair market value (a) as a dividend to the extent that it is covered by earnings and profits and (b) as a non-dividend distribution, applicable in reduction of basis under §301(c)(2) and taxable thereafter under §301(c)(3), to the extent that it exceeds the earnings and profits. Regs. §1.316-1(a)(3), Example. (Corporate shareholders of the distributing corporation are governed by the special rule of §301(b)(1)(B).) Under the 1939 Code, it was held that the fair market value of the distributed property was taxable as a dividend in full if the corporation's earnings and profits exceeded its basis for the property. Commissioner v. Godley's Estate, 213 F.2d 529 (3d Cir. 1954); Commissioner v. Hirshon Trust, 213 F.2d 523 (2d Cir. 1954). The Treasury's proposed Regulations under the 1954 Code adhered to the position upheld by the courts in these cases, but the final Regulations accept the view that these cases were overruled by the 1954 Code.

See generally Mintz and Plumb, Dividends in Kind — The Thunderbolts and the New Look, 10 Tax L. Rev. 41 (1954), with a Postscript, id. at 405; Bittker, Stock Dividends, Distributions in Kind, Redemptions and Liquidations Under the 1954 Code, 1955 So. Calif. Tax Inst. 349, 358-370.

COMMISSIONER v. FIRST STATE BANK OF STRATFORD

168 F.2d 1004 (5th Cir. 1948), cert. denied, 335 U.S. 867 (1948)

Before SIBLEY, HUTCHESON, HOLMES, MCCORD, WALLER, and LEE, Circuit Judges.

HOLMES, Circuit Judge:

The Commissioner is seeking the correction of errors alleged to have been made by the Tax Court in its decision in this case. The question for decision is whether certain recoveries on notes in 1942 were income to the taxpayer, the respondent on review.

On October 17, 1942, the First State Bank of Stratford declared a dividend in kind, which consisted of certain notes that had been charged off as wholly worthless, and deducted as bad debts in its income-tax returns for years previous to 1942. These notes did not appear on the bank's books. They had been kept in a case by themselves, but were brought to the directors' meeting on the above date, when the possibility of their collection was discussed. It then appeared that collections on the notes were currently being made, about $25,000 already having been collected. The payment of a dividend by the bank was next considered. Attention was called to the matter of increased taxes and the advisability of deferring a cash dividend until more would be known about the new income-tax law soon to be enacted. It was pointed out that the bank had a number of charged-off accounts of doubtful value, also real estate carried on the books at the nominal sum of one dollar. The advisability of paying a dividend in these properties was fully considered, and the following resolution adopted:

> Whereas, This bank is the owner of several thousand dollars of charged off notes, some of which may be collected in future, and the balance of which are of doubtful value.
>
> Now, Therefore, Be it resolved that the following charged off notes be assigned to the stockholders of this bank without recourse on it, said notes being paid as a dividend in kind and without any value being placed thereon by this bank. (A list and description of the notes followed.)

After the meeting the directors, as stockholders, further discussed the matter. It was suggested, with approval, that W. N. Price take charge of the notes for the stockholders. Within the next few days, the notes included in the dividend were endorsed to W. N. Price without recourse on the bank. Amounts thereafter collected in 1942 on the dividend notes were deposited in the bank in an account designated "W. N. Price, Special." In attempting collection of these notes, Price, who worked in the bank, did nothing that he did not do in collecting notes owed to the bank, except at various times he worked after banking hours. No system of bookkeeping for the notes was set up by the stockholders in 1942. The debtors were not notified of the assignment of their debts to the stockholders. The notes when paid were marked paid with a stamp on which appeared the bank's name, but not the stockholders'.

After October 17, 1942, and prior to January 1, 1943, collections amounting to $11,662.71 were made on these dividend notes, of which the sum of $10,548.20 was determined by the Commissioner to be taxable income of the respondent on the theory that to this extent the distribution of the dividend in kind merely represented an assignment of anticipated income, because a tax benefit had been

received for it in prior years. The Tax Court reversed the Commissioner's determination, and held that the amounts so collected were not taxable to the respondent as income. . . .

A dividend to a shareholder by a corporation in any medium other than money is a dividend in kind, and in a formal sense the notes here represented such a dividend. Ordinarily no gain or loss is realized by a corporation from the mere distribution of its assets in kind in partial or complete liquidation, however they may have appreciated or depreciated in value since their acquisition but the rule is deemed to be otherwise where the dividend in kind is not in liquidation and consists of bad debts on account of the worthlessness of which a deduction was allowed for a prior taxable year. Whether or not the respondent corporation made an assignment of anticipatory income upon the distribution of its dividend in kind depends upon the nature of the property distributed in relation to the capital structure of the corporation. In this case, the charged-off debts no longer represented an asset except in the sense that any vested right to receive income is an asset; the notes had a basis of zero, and were no longer reflected in the capital structure of the corporation. They merely represented potential income to the extent of the tax deduction previously allowed.

The Tax Court distinguished [Helvering v. Horst, 311 U.S. 112, and Helvering v. Eubank, 311 U.S. 122] because in them the anticipatory assignments were without consideration, which is not true as to a dividend in kind. We think the question of consideration is not controlling or even important here. The question is one of the realization of income. Property may be disposed of by gift, sale, exchange, or abandonment, among which only abandonment could involve no taxable gain. The distribution of a dividend in kind is none of these. It is a delivery or assignment of property to its equitable owners. In this case, a sale or exchange of the notes would doubtless have resulted in the realization of a taxable gain, but no such disposition was required to realize income. The notes as collected would have been income to the corporation, and they were nonetheless the fruition of economic gain when collected by the assignees. It is the realization of income, rather than the acquisition of the right to receive it, that is the taxable event, and there is no reason why the rule that income tax is not to be avoided by an anticipatory assignment of income shall not apply to dividends. When not received in money or property, realization may occur when the last step is taken by which one obtains the fruition of the economic gain. . . .

The notes were assets of the bank, and subject to transfer as other property, but they were not capital assets for income-tax purposes. The amount determined by the Commissioner to be income to the bank consisted of collections on the principal of the debts represented by the notes and perhaps of some interest that had accrued prior to the assignments. The principal was overdue and payable to the bank prior to the dividend declaration. Therefore, in declaring a dividend of the notes and assigning them without recourse, the bank assigned its vested right to receive the income that the notes represented. As the Supreme Court said in Harrison v. Schaffner, 312 U.S. 579, 581-582:

> In construing these and like provisions in other revenue acts we have uniformly held that they are not so much concerned with the refinements of title as with the actual command over the income which is taxed and the actual benefit for which the tax is paid. See Corliss v. Bowers, 281 U.S. 376; Lucas v. Earl [281 U.S. 111]; Helvering v. Horst, supra; Helvering v. Eubank, supra; Helvering v. Clifford [309 U.S. 331]. It was for that reason that in each of those cases it was held that one vested with the right to receive income did not escape the tax by any kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another, since, by the exercise of his power to command the income, he enjoys the benefit of the income on which the tax is laid.

Therefore, as a matter of law, under the anticipatory assignment-of-income rule, the respondent's declaration of a dividend, its assignment of the notes, and their subsequent collection, must be treated as if the bank had thereby realized income. The facts indisputably show that the bank was making collections on these notes and declared a dividend only of the notes on which it was expected collections would be made. Over $11,000 was collected in the two-and-a-half months of the taxable year remaining after the dividend declaration. The collections were made at the bank by an officer of the bank. No pro rata distribution to stockholders was effected prior to collections, and the notes were not in any manner apportioned among the stockholders. The dividend in kind was declared and the notes assigned by the respondent with tax consequences in mind and, so far as the record shows, for no other purpose. . . . The respondent is a banking corporation, organized and operated for profit. The acquisition of profits for its shareholders was the purpose of its creation. The collection of interest on loans was a principal source of its income. The payment of dividends to its shareholders was the enjoyment of its income. A body corporate can be said to enjoy its income in no other way. Like the "life-rendering pelican," it feeds its shareholders upon dividends. Whether they are in the form of notes or money is immaterial if the dividend is out of earnings, or consists of property purchased from earnings or which is regarded as earnings for accounting purposes. The respondent exercised its power to procure payment of its income to another, which was "the enjoyment, and hence the realization," of its income.

The distinction between General Utilities v. Helvering [296 U.S. 200], and this case lies in the difference in the character of the respective properties distributed as dividends in kind; one represented a capital asset, the other represents income. In the former, the fruit was on the tree; in the latter, the tree itself represents fruit of prior years that was not taxed. The distinction is the same as would have existed in the *Horst* case if the father had given his son the bond with the unearned-interest coupon attached. . . .

Reversed.

SIBLEY, Circuit Judge, concurring:

I concur in the judgment of reversal and the reasoning of the majority opinion, but I wish to express an additional view which seems to me simpler and more fundamental. . . .

[T]he present case . . . involves the proper tax treatment of a large aggregate of debts due to the corporation which in past years the corporation, on its representation that they were bad debts and a loss, had been permitted to deduct as such with a full resulting tax benefit. This deduction was not of constitutional right, but of legislative grace, and was allowed on terms stated in applicable Regulations. Beginning in 1918 Article 52 of Regulation 45 said:

> Bad debts or accounts charged off because of the fact that they were determined to be worthless, which are subsequently recovered, whether or not by suit, constitute income for the year in which recovered, regardless of the date when the amounts were charged off.

This language was continued down through Regulation 103, Sect. 19.42-1, under the [1939] Revenue Code, when the deductions were made and allowed which are now in controversy.* The restoration to income of all subsequent recoveries was a condition of the deductions. The making of this adjustment in its tax accounts with the Government became the legal and the moral duty of this corporation. When in the tax year it found it was making collections on these charged-off debts, and would likely collect considerable sums, it was not free in law or morals to evade its tax duty by turning the bad debts over to its stock-

* The corresponding provision of the Regulations under the 1954 Code is Regs. §1.166-1(f). — ED

holders for them to collect. The directors picked out only debts that were regarded as likely to yield collections, keeping those that were wholly bad. They did not divide them among the stockholders, but the five directors turned the hopeful debts over to one of themselves, he being vice-president and cashier of the bank, and he collected in the name of the bank, deposited the collections in the bank, and then later distributed the money to the stockholders. The stockholders returned nothing for taxation till each got his money in later years. I think there was in reality nothing divided as a dividend to the stockholders till the money was paid them, and in reality the bank made the recoveries on the charged-off debts, and the Tax Court ought to have so held. But if this were a real distribution of undivided property to the stockholders, the bank could not thus free itself of the accounting obligation which it assumed in taking the bad debt deductions. For this purpose the receipt of payments by the stockholders is receipt by their corporation. All that was said in United States v. Joliet & Chicago R. Co., 315 U.S. 44, as to the force of Regulations and the ineffectualness of anticipating arrangements to evade taxes made between stockholders and their corporation, may be applied to this case. Another instance in which Regulations were held to inhere in deductions so as to require a restoration to income accordingly, though nothing was received in the tax year, is Sneed v. Commissioner, 119 F.2d 767. (Cert. denied.) This bank had no option to avoid incurring a tax by a lawful course. The course it took was not lawful because of the obligation assumed in taking the deductions with full tax benefits at the time.

JUDGE MCCORD and LEE also concur in the additional views expressed in the above opinion.

HUTCHESON, Circuit Judge, dissenting:

I agree with the conclusion of the Tax Court that the distribution to its stockholders of the notes in question was not a realization of income by it. I agree too with the reasons it gave for so concluding. I, therefore, dissent from the opinion of the majority.

WALLER, Circuit Judge, dissenting:

I think, as did the Tax Court, that this case is controlled by General Utilities Company v. Helvering, 296 U.S. 200. I think further that even if there were some sort of tax liability to the Bank, it should be measured by the reasonable, or market, value, at the time of the making of the dividend-in-kind, of the charged-off securities, rather than by the collections thereafter made by the stockholders when improved financial conditions, increase in values, enlargement of opportunities, greater availability for refinancing of loans, such as the Court of its own knowledge knows has attended the lush period since the assignments were made, aided the makers in paying obligations which they could not have paid theretofore.

Moreover, I do not think that the doctrine in Helvering v. Horst, 311 U.S. 112, can rightly be stretched to cover this case for the chief reason that the action of the stockholders in agreeing to accept a dividend-in-kind in lieu of a dividend in a fixed percentage cannot truly be said to be without consideration. True it is that the stockholders owned the Bank, but the law does not contemplate that banks shall be one with their stockholders.

The ascertainment of the correct amount of taxes due on income actually received is already difficult and onerous enough without, through judicial processes, adding to the taxpayer's perplexity and burden by requiring him to compute and pay taxes on income merely anticipated but never received, but which has theretofore been assigned in due and lawful course of business.

I do not consider these assignments as gratuitous transfers of income already earned and readily collectible, such as characterized the interest coupons in the

Horst case, supra. I, therefore, must dissent to the learned and persuasive opinion of the majority in this case.

NOTE

Effect of §311. In recommending the enactment of §311 in 1954, the Senate Finance Committee Report stated:

> [Y]our committee does not intend to change existing law with respect to attribution of income of shareholders to their corporation as exemplified for example in the case of Commissioner v. First State Bank of Stratford.

Does the court hold in the *Stratford Bank* case that the bank must report as income the difference between the basis of the notes (zero) and their fair market value at the time of distribution, or is the bank taxable only when, as, and if the notes are paid by the obligors?

Many assets have a zero basis because their cost was deducted in prior years: fully depreciated equipment and buildings, goodwill, industrial know-how and patents if the taxpayer amortized its research and experimental expenditures under §174, trademarks and trade names if expenditures were amortized under §177, etc. Does the *Straford Bank* case imply that income is recognized on a distribution of such assets?

Section 311 speaks of a distribution of "property." Recall the cases (supra pages 527 et seq.) holding that some assets are not "property" as that term is used in §1221 and that others do not qualify as capital assets because they represent future income. Do assets of this type fall outside of §311? If so, does it necessarily follow that their distribution generates income?

IDAHO FIRST NATIONAL BANK v. UNITED STATES

265 F.2d 6 (9th Cir. 1959)

Before POPE, HAMLEY and HAMLIN, Circuit Judges.

POPE, Circuit Judge.

This was an action brought to recover a sum paid under protest as an assessed deficiency in income taxes. The deficiency was assessed against the plaintiff bank, appellant here, as transferee of the assets of the Wendell National Bank of Wendell, Idaho; that is to say, the taxable income here in question was that of Wendell National Bank.

Wendell National Bank had operated for many years when, on May 10, 1952, appellant bank purchased from Wendell's stockholders all of that bank's stock for the purpose of acquiring its assets. The same day, Wendell was dissolved and all its assets and liabilities distributed to appellant.

Included in these assets were notes evidencing outstanding loans of the Wendell bank on which neither principal nor interest was then due or payable. At the time of liquidation the accrued interest earned but not then payable on these notes receivable was computed. It totaled some $13,191.19.[1]

The Wendell bank had always reported its income for tax purposes on the cash basis method of accounting. After the liquidation, and on June 20, 1952, a corporation income tax return for the period January 1, 1952 through May 10, 1952, was filed on its behalf.

After several false starts appellant took the position that this interest, accrued but not yet due or payable, could not be included as taxable income to the Wendell bank. Its position then and now, was and is that since the Wendell bank

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1 Expenses attributable to this accrued interest on notes receivable had been deducted for income tax purposes when paid by the Wendell National Bank prior to its liquidation. Unpaid accrued expenses of the Wendell National Bank had not been deducted for income tax purposes at the date of liquidation.

had consistently reported its income and deductions for income tax purposes on a cash receipts and disbursements method of accounting, the Commissioner was without power to include in its income interest that was neither due nor payable on unmatured notes. The Commissioner, however, ruling that the accrued interest on notes receivable should be included as taxable income of the Wendell bank, assessed as a deficiency the additional tax called for by that ruling. Plaintiff, liable as assignee of assets, paid the amount assessed under protest, filed claim for refund, and on its rejection brought this suit.

When interest on the notes here described was ultimately collected by appellant, it reported it as income but offset the collections against the allocated cost of the accrued interest on notes receivable, so that all of the amount collected was recovery of cost and not subject to income tax.

In making his ruling the Commissioner relied upon [§446(b)], providing that if the taxpayer's method of accounting "does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income."

As the stipulation of facts recognizes, this interest was "accrued" in that it was an asset, so treated for bookkeeping purposes. All services or extensions of credit necessary to establish the right to this interest and income had been executed. In substance and effect, though the disposition of the assets was accomplished through the device of selling and buying the stock of the shareholders, the Wendell bank realized income in the amount of the interest accrued just as if it had sold its assets under an arrangement whereby the value of the accrued interest was calculated as a part of the purchase price. Thus it may be suggested that the amount here involved was collected as part of the purchase price. Floyd v. Scofield, 5 Cir., 193 F.2d 594, 595. The application in that case of the principles expressed in Helvering v. Horst, 311 U.S. 112, and in Hort v. Commissioner, 313 U.S. 28, was expressly approved by this court in United States v. Snow, 9 Cir., 223 F.2d 103, 109.

We think it plain that the action of the Commissioner in invoking his power under [§446(b)], to impose a method of accounting calculated to reflect the realities of the situation was clearly proper. For, as indicated above, when this interest was ultimately collected by appellant it was not income to it; — as the parties have stipulated, "all the amount collected was recovery of cost and not subject to income tax."

In this holding that the action of the Commissioner was authorized by [§446(b)], we are supported by authority. In Jud Plumbing and Heating Company v. Commissioner, 5 Cir., 153 F.2d 681, a corporation reporting on the completed contract method was held properly placed on the accrual method for the tax period terminating with the corporate liquidation in order more clearly to reflect its income for the final period of its existence. The *Jud Plumbing* case was cited and approved by this court in a case where we likewise upheld a similar application of [§446(b)]. United States v. Lynch, 9 Cir., 192 F.2d 718, 721.

Standard Paving Co. v. Commissioner, 10 Cir., 190 F.2d 330, 332, was another case, like *Jud Plumbing*, supra, where a corporation had previously reported income on a completed contract basis. When certain construction contracts undertaken by the corporation were still uncompleted, its stock, all owned by a parent company, was surrendered and canceled and the corporation dissolved. For the final period of its existence the corporation reported no income from these contracts. The Commissioner allocated a percentage of the total profit, computed to the date of dissolution, to the corporation's income. The Commissioner's position was that the strict application of the completed contract method did not clearly reflect the income. He thereupon exercised the authority granted by

[§446(b)]. Said the Court: "[§446(b)] of the Internal Revenue Code . . . provides that if the method of accounting regularly employed by the taxpayer does not clearly reflect the income, the computation shall be made in accordance with such method as, in the opinion of the Commissioner, does clearly reflect the income. The statute gives the Commissioner broad discretion in adopting a method which he believes properly reflects the income of the taxpayer. . . . His selection of such a method may be challenged only upon a clear showing that he had abused his discretion."

For the reasons there expressed we think the action of the Commissioner here was proper, and the assessment correct.

Appellant claims that the Wendell bank had expenses attributable to this accrued interest, and that the Commissioner failed to accrue those to the date of liquidation. As to those expenses, the parties stipulated that the facts were as stated in footnote 1, supra, which suggests that expenses had been deducted currently prior to the liquidation. If any were not so deducted, it was up to the taxpayer to prove their amount in the court below. In not doing so, it lost the right to argue about them now.

The judgment is affirmed.

NOTE

1. *Life-after-death?* If the notes had been delinquent, as in the *Stratford Bank* case, would the accrued income have been taxable when the notes were distributed? If the prospect of collecting past-due interest is not susceptible to valuation, should the dissolved bank be taxed when, as, and if collections are made by its successor? Although Judge L. Hand evidently believed in life-after-death for the dissolved corporation, he acknowledged that other courts were shocked by the idea and made no effort to proselyte for it. J. Ungar, Inc. v. Commissioner, 244 F.2d 90 (2d Cir. 1957); Telephone Directory Adv. Co. v. United States, 142 F. Supp. 884 (Ct. Cl. 1956) (nothing in tax law "requires a corporation, which has employed an accrual method of accounting that properly reflected its income over a period of years, to remain in existence for the sole purpose of paying taxes after it is forced to discontinue business").

2. *Effect of §334(b)(2).* In the *Idaho Bank* case, the court noted that the successor bank treated its collection of interest accrued before the distribution as a recovery of its cost, presumably under the "Kimbell-Diamond" doctrine, supra page 652, now embodied in §334(b)(2). For a dramatic illustration of the effect of §334(b)(2), see South Lake Farms, Inc. v. Commissioner, 324 F.2d 837 (9th Cir. 1963). The taxpayer in this case, a corporation, purchased all of the stock of a second corporation which had incurred and deducted about $700,000 as expenses in raising an agricultural crop and preparing land for planting another crop. Before the crops were ready for harvesting, the taxpayer liquidated the old corporation; under §334(b)(2), its basis for the property thus received was equal to the amount it had paid for the stock, and there was little additional income to be realized when the crops were sold. The Commissioner's attempt to disallow the expenses incurred by the old corporation (which had created an operating loss, carried back to profitable earlier years to obtain a tax refund) was unsuccessful. Cf. Rooney v. United States, supra page 638.

3. *The contracts in the Carter case.* Does the *Carter* case, supra page 649, imply that the corporation realized no income on distributing these contracts? The Tax Court held that corporate income was realized on another contract, not involved in the appellate proceeding in *Carter* because payments under it were not contingent on any post-distribution events, 9 T.C. 373 (1947).

2. *Shareholder Transactions Imputed to the Corporation: The Court Holding Co. Case and §337*

Section 337 of the 1954 Code, providing for the non-recognition of gain or loss by a liquidating corporation on certain sales and exchanges, has no counterpart in the 1939 Code.

Section 336 is also new in the 1954 Code, but it is based on a provision in Regs. 118, §39.22(a)-20.

COMMISSIONER v. COURT HOLDING CO.

324 U.S. 331 (1945)

MR. JUSTICE BLACK delivered the opinion of the Court.

An apartment house, which was the sole asset of the respondent corporation, was transferred in the form of a liquidating dividend to the corporation's two shareholders. They in turn formally conveyed it to a purchaser who had originally negotiated for the purchase from the corporation. The question is whether the Circuit Court of Appeals properly reversed the Tax Court's conclusion that the corporation was taxable under [1939 Code, §22(a)] [1] for the gain which accrued from the sale. The answer depends upon whether the findings of the Tax Court that the whole transaction showed a sale by the corporation rather than by the stockholders were final and binding upon the Circuit Court of Appeals.

It is unnecessary to set out in detail the evidence introduced before the Tax Court or its findings. Despite conflicting evidence, the following findings of the Tax Court are supported by the record:

The respondent corporation was organized in 1934 solely to buy and hold the apartment building which was the only property ever owned by it. All of its outstanding stock was owned by Minnie Miller and her husband. Between October 1, 1939 and February, 1940, while the corporation still had legal title to the property, negotiations for its sale took place. These negotiations were between the corporation and the lessees of the property, together with a sister and brother-in-law. An oral agreement was reached as to the terms and conditions of sale, and on February 22, 1940, the parties met to reduce the agreement to writing. The purchaser was then advised by the corporation's attorney that the sale could not be consummated because it would result in the imposition of a large income tax on the corporation. The next day, the corporation declared a "liquidating dividend," which involved complete liquidation of its assets, and surrender of all outstanding stock. Mrs. Miller and her husband surrendered their stock, and the building was deeded to them. A sale contract was then drawn, naming the Millers individually as vendors, and the lessees' sister as vendee, which embodied substantially the same terms and conditions previously agreed upon. One thousand dollars, which a month and a half earlier had been paid to the corporation by the lessees, was applied in part payment of the purchase price. Three days later, the property was conveyed to the lessees' sister.

The Tax Court concluded from these facts that, despite the declaration of a "liquidating dividend" followed by the transfers of legal title, the corporation had not abandoned the sales negotiations; that these were mere formalities de-

[1] Profits from the sale of property are taxable as income under [1939 Code, §22(a)]. The Treasury Regulations have long provided that gains accruing from the sale of a corporation's assets, in whole or in part, constitute income to it, but that a corporation realizes no taxable gain by a mere distribution of its assets in kind, in partial or in complete liquidation, however much they may have appreciated in value since acquisition. Regs. 118, Sec. 39.22(a)-20. [This rule is now embodied in 1954 Code, §336, supra page 666.]

signed "to make the transaction appear to be other than what it was," in order to avoid tax liability. The Circuit Court of Appeals drawing different inferences from the record, held that the corporation had "called off" the sale, and treated the stockholders' sale as unrelated to the prior negotiations.

There was evidence to support the findings of the Tax Court, and its findings must therefore be accepted by the courts. Dobson v. Comm'r, 320 U.S. 489. . . . On the basis of these findings, the Tax Court was justified in attributing the gain from the sale to respondent corporation. The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

It is urged that respondent corporation never executed a written agreement, and that an oral agreement to sell land cannot be enforced in Florida because of the Statute of Frauds, Comp. Gen. Laws of Florida, 1927, vol. 3, Sec. 5779, F.S.A. §725.01. But the fact that respondent corporation itself never executed a written contract is unimportant, since the Tax Court found from the facts of the entire transaction that the executed sale was in substance the sale of the corporation. The decision of the Circuit Court of Appeals is reversed, and that of the Tax Court affirmed.

It is so ordered.

Reversed.

NOTE

1. *Adjustment for transferee liability.* Note that the Court Holding Company is without assets to pay the tax that the Court finds to be due. The tax must therefore be paid by those who rendered the corporation insolvent, namely, the stockholders. In effect, they overpaid their personal taxes in the year the assets were distributed, since they calculated their capital gain or loss on the liquidation without allowing for the corporation's tax liability. For the proper adjustment at the shareholder level, see Arrowsmith v. Commissioner, supra page 532; §1341.

2. *Life-after-death again?* In view of the judicial reluctance to impute income to a dissolved corporation (supra p. 674), what would have been the result if the sale in *Court Holding Co.* had been on credit, with payment to be made in installments (with interest) over a period of many years?

UNITED STATES v. CUMBERLAND PUBLIC SERVICE CO.

338 U.S. 451 (1950)

MR. JUSTICE BLACK delivered the opinion of the Court.

A corporation selling its physical properties is taxed on capital gains resulting from the sale. There is no corporate tax, however, on distribution of assets in kind to shareholders as part of a genuine liquidation. The respondent corporation transferred property to its shareholders as a liquidating dividend in kind. The shareholders transferred it to a purchaser. The question is whether, despite contrary findings by the Court of Claims, this record requires a holding that the transaction was in fact a sale by the corporation subjecting the corporation to a capital gains tax.

Details of the transaction are as follows. The respondent, a closely held corporation, was long engaged in the business of generating and distributing electric power in three Kentucky counties. In 1936 a local cooperative began to distribute Tennessee Valley Authority power in the area served by respondent. It soon became obvious that respondent's Diesel-generated power could not compete with TVA power, which respondent had been unable to obtain. Respondent's shareholders, realizing that the corporation must get out of the power business unless it obtained TVA power, accordingly offered to sell all the corporate stock to the cooperative, which was receiving such power. The cooperative refused to buy the stock, but countered with an offer to buy from the corporation its transmission and distribution equipment. The corporation rejected the offer because it would have been compelled to pay a heavy capital gains tax. At the same time the shareholders, desiring to save payment of the corporate capital gains tax, offered to acquire the transmission and distribution equipment and then sell to the cooperative. The cooperative accepted. The corporation transferred the transmission and distribution systems to its shareholders in partial liquidation. The remaining assets were sold and the corporation dissolved. The shareholders then executed the previously contemplated sale to the cooperative.

Upon this sale by the shareholders, the Commissioner assessed and collected a $17,000 tax from the corporation on the theory that the shareholders had been used as a mere conduit for effectuating what was really a corporate sale. Respondent corporation brought this action to recover the amount of the tax. The Court of Claims found that the method by which the stockholders disposed of the properties was avowedly chosen in order to reduce taxes, but that the liquidation and dissolution genuinely ended the corporation's activities and existence. The court also found that at no time did the corporation plan to make the sale itself. Accordingly it found as a fact that the sale was made by the shareholders rather than the corporation, and entered judgment for respondent. One judge dissented, believing that our opinion in Court Holding Co. v. Com'r, 324 U.S. 331, required a finding that the sale had been made by the corporation. Certiorari was granted to clear up doubts arising out of the *Court Holding Co.* case.

Our *Court Holding Co.* decision rested on findings of fact by the Tax Court that a sale had been made and gains realized by the taxpayer corporation. There the corporation had negotiated for sale of its assets and had reached an oral agreement of sale. When the tax consequences of the corporate sale were belatedly recognized, the corporation purported to "call off" the sale at the last minute and distributed the physical properties in kind to the stockholders. They promptly conveyed these properties to the same persons who had negotiated with the corporation. The terms of purchase were substantially those of the previous oral agreement. One thousand dollars already paid to the corporation was applied as part payment of the purchase price. The Tax Court found that the corporation never really abandoned its sales negotiations, that it never did dissolve, and that the sole purpose of the so-called liquidation was to disguise a corporate sale through use of mere formalisms in order to avoid tax liability. The Circuit Court of Appeals took a different view of the evidence. In this Court the Government contended that whether a liquidation distribution was genuine or merely a sham was traditionally a question of fact. We agreed with this contention, and reinstated the Tax Court's findings and judgment. Discussing the evidence which supported the findings of fact, we went on to say that "the incidence of taxation depends upon the substance of a transaction" regardless of "mere formalisms," and that taxes on a corporate sale cannot be avoided by using the shareholders as a "conduit through which to pass title."

This language does not mean that a corporation can be taxed even when the

sale has been made by its stockholders following a genuine liquidation and dissolution.[1] While the distinction between sales by a corporation as compared with distribution in kind followed by shareholder sales may be particularly shadowy and artificial when the corporation is closely held, Congress has chosen to recognize such a distinction for tax purposes. The corporate tax is thus aimed primarily at the profits of a going concern. This is true despite the fact that gains realized from corporate sales are taxed, perhaps to prevent tax evasions, even where the cash proceeds are at once distributed in liquidation. But Congress has imposed no tax on liquidating distributions in kind or on dissolution, whatever may be the motive for such liquidation. Consequently, a corporation may liquidate or dissolve without subjecting itself to the corporate gains tax, even though a primary motive is to avoid the burden of corporate taxation.

Here, on the basis of adequate subsidiary findings, the Court of Claims has found that the sale in question was made by the stockholders rather than the corporation. The Government's argument that the shareholders acted as a mere "conduit" for a sale by respondent corporation must fall before this finding. The subsidiary finding that a major motive of the shareholders was to reduce taxes does not bar this conclusion. Whatever the motive and however relevant it may be in determining whether the transaction was real or a sham, sales of physical properties by shareholders following a genuine liquidation distribution cannot be attributed to the corporation for tax purposes.

The oddities in tax consequences that emerge from the tax provisions here controlling appear to be inherent in the present tax pattern. For a corporation is taxed if it sells all its physical properties and distributes the cash proceeds as liquidating dividends, yet is not taxed if that property is distributed in kind and is then sold by the shareholders. In both instances the interest of the shareholders in the business has been transferred to the purchaser. Again, if these stockholders had succeeded in their original effort to sell all their stock, their interest would have been transferred to the purchasers just as effectively. Yet on such a transaction the corporation would have realized no taxable gain.

Congress having determined that different tax consequences shall flow from different methods by which the shareholders of a closely held corporation may dispose of corporate property, we accept its mandate. It is for the trial court, upon consideration of an entire transaction, to determine the factual category in which a particular transaction belongs. Here as in the *Court Holding Co.* case we accept the ultimate findings of fact of the trial tribunal. Accordingly the judgment of the Court of Claims is affirmed.

Affirmed.

MR. JUSTICE DOUGLAS took no part in the consideration or decision of this case.

NOTE

1. *Status of buyer of stock if corporation is liquidated.* Note that the *Cumberland* shareholders offered to sell their stock to the potential vendee. What tax and non-tax reasons might cause the vendee to refuse to buy stock and to insist instead upon purchasing the assets? If the vendee had bought the stock for the announced purpose of obtaining the assets by liquidating the corporation, would the sellers have been protected against

[1] What we said in the *Court Holding Co.* case was an approval of the action of the Tax Court in looking beyond the papers executed by the corporation and shareholders in order to determinate whether the sale there had actually been made by the corporation. We were but emphasizing the established principle that in resolving such questions as who made a sale, fact finding tribunals in tax cases can consider motives, intent, and conduct in addition to what appears in written instruments used by parties to control rights as among themselves. See, e.g., Helvering v. Clifford, 309 U.S. 331, 335-337; Commissioner v. Tower, 327 U.S. 280.

the possibility of a second tax? Note that the buyer might have relied on the "Kimbell-Diamond" principle, supra page 652, to establish that the transaction was "really" a purchase of assets rather than a purchase of stock. If this assertion was accepted, would it follow that the liquidated corporation had sold its assets? If so, who must pay the tax that the liquidated corporation is unable to pay? See Magill, Sales of Corporate Stock or Assets, 47 Colum. L. Rev. 707 (1947).

2. *Strategy to avoid Court Holding Co. doctrine.* Did the procedure followed by the shareholders in the *Cumberland Public Service Co.* case differ from that followed in *Court Holding Co.* only because the former shareholders consulted their lawyer early enough so that they were not forced to "call off" an agreed-upon sale? Did the *Cumberland Public Service Co.* case provide a safe pattern to emulate, or would cautious lawyers advise their clients to liquidate the corporation before even talking with prospective buyers of the assets? If so, what practical difficulties would there be in a liquidate-first-talk-later procedure?

3. *The statutory remedy of §337.* Section 337 was enacted in 1954 to provide a statutory rule to govern this much-litigated area. It is examined in the ruling and editor's note following.

REV. RUL. 61-214

1961-2 C.B. 60

Advice has been requested whether, in connection with a sale of corporate assets, certain recoveries of items which previously had been deducted for Federal income tax purposes are to be treated as proceeds of a nontaxable sale under the provisions of section 337(a) of the Internal Revenue Code of 1954.

An office building corporation, availing itself of the benefits of section 337 of the Code, adopted a plan of complete liquidation and within the 12-month period sold its entire assets to a single buyer. Included in the sale were a stock-pile of coal, plumbing supplies, and small tools. The costs of such items had been deducted in full in taxable years prior to the year of the sale.

Section 337(a) of the Code, pertaining to gain or loss on sales or exchanges in connection with certain liquidations, sets forth the general rule that, if a corporation adopts a plan of complete liquidation on or after June 22, 1954, and, within the 12-month period beginning on the date of the adoption of such plan, all of the assets of the corporation are distributed in complete liquidation, less assets retained to meet claims, then no gain or loss shall be recognized to such corporation from the sale or exchange by it of property within such 12-month period.

The provisions of section 337(a) apply only to gain or loss from the "sale or exchange" of property. In the instant case, part of the proceeds from the sale is, in reality, a recovery of amounts previously deducted for Federal income tax purposes. Thus, that part is not to be treated as gain from the sale of assets, but, rather, is subject to the rule that a recovery of an amount previously deducted constitutes ordinary income to the extent of a prior tax benefit. See Rev. Rul. 60-49, C.B. 1960-1, 148; Central Building and Loan Association v. Commissioner, 34 T.C. 447 (1960); First State Bank of Stratford v. Commissioner, 168 Fed. (2d) 1004 (1948), certiorari denied, 335 U.S. 867 (1948).

In view of the foregoing, it is held that in the instant case the portion of the proceeds representing a recovery of the amounts of such items which previously had been deducted for Federal income tax purposes is to be treated as ordinary income to the corporation under section 61 of the Code and not as nonrecognized gain under the provisions of section 337(a) of the Code.

NOTE

1. *Types of gain not embraced by §337.* Section 337 grants immunity only to gain (or loss) "from the sale or exchange by [the liquidating corporation] of property." Does the term "sale or exchange" as used in §337 have the same meaning as in §1222 (defining capital gain, capital loss, etc.)? In Towanda Textiles, Inc. v. United States, 180 F. Supp. 373 (Ct. Cl. 1960), it was held that an involuntary conversion (destruction by fire and recovery of insurance proceeds) constitutes a "sale or exchange" under §337, because §1231 provides that it shall be so considered, although it is not a "sale or exchange" under §1222; it is not clear whether court would rule the same way if the property that was destroyed was not §1231 property. See also Rev. Rul. 64-100, 1964-13 I.R.B. 8 (conversions are within §337, whether property is described in §1231 or not and regardless of holding period).

Does Rev. Rul. 61-214 deny that the materials and supplies were "sold"? Does the ruling suggest that the Internal Revenue Service is embarked on a "recapture" program modeled on §1245 but broader in scope? Or is the ruling merely an application of Perry v. United States, supra page 75? The ruling cites the *Stratford Bank* case, supra page 668, Central Building & Loan Assn. v. Commissioner (interest accrued to the date of liquidation on notes sold by the taxpayer is recognized despite §337; Tax Court's decision affirmed, 288 F.2d 47 (9th Cir. 1961)), and Rev. Rul. 60-49 (on a tax-free one-month liquidation under §333, the distributee must report as income amounts that represent refunds of amounts previously deducted). Would Rev. Rul. 61-214 also require the items mentioned in the editor's note following the *Stratford Bank* case to be recognized on a §337 liquidation? See also, for cases requiring the liquidating corporation to recognize income despite §337, West Seattle Nat. Bank v. Commissioner, 33 T.C. 341 (1959) (bad debt reserve when assets were sold for full book value); Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962) (gain on sale of construction contracts); Family Record Plan v. Commissioner, 309 F.2d 208 (9th Cir. 1962) (accounts receivable sold by cash basis taxpayer). In addition to such items, §337 itself denies non-recognition to sales of inventory and installment obligations arising from the sale of inventory, unless they are sold in bulk to a single buyer.

Do these limitations suggest that a corporate liquidation on the *Cumberland Public Service Co.* pattern, followed by a sale of the assets by the shareholders, may be preferable in some circumstances to a §337 sale-and-liquidation?

2. *Critical dates under §337.* The date the plan of liquidation is adopted is critical to the application of §337, since (a) sales and exchanges *after* that date are the only ones to which non-recognition of gain or loss applies, and (b) the liquidating distribution or distributions must be complete within twelve months after the plan is adopted. For problems in determining when the plan is "adopted," see Regs. §1.337-2(b); Mountain Water Co. v. Commissioner, 35 T.C. 418 (1960), and cases there cited. If a corporation "straddles" §337 by carefully selling its depreciated assets before adopting a formal plan of liquidation, and then proceeding to adopt a formal plan and to sell its appreciated assets, can its decision to split the sales in this manner be regarded as the informal adoption of a plan of liquidation? See City Bank of Washington v. Commissioner, 38 T.C. 713 (1962) ("straddle" not objectionable).

Sometimes the date of a sale or exchange, rather than the date the plan was adopted, is in dispute. See 44 West 3d St. Corp. v. Commissioner, 39 T.C. 809 (1963) (condemnation by municipal government qualifies as a "sale" under §337, but it occurred before the plan was adopted).

A final crucial date under §337 is the date the liquidating distribution is complete. See *Mountain Water Co.*, supra; Milwaukee Sanitarium v. United States, 193 F. Supp. 299 (E.D. Wis. 1961).

Note that timing is also critical in a one-month liquidation under §333, supra page 651.

3. *Limited jurisdiction of §337.* Section 337 applies only if the corporation is completely liquidated. If the corporation sells part of its assets and then distributes the proceeds in partial liquidation under §331(a)(2) or in a disproportionate or complete redemption under §302(b), there will be a tax at the corporate level and a second tax to the

shareholders (assuming that the sales price exceeds the corporation's basis for the property and that the distribution exceeds the shareholders' basis for their stock). Moreover, even if there is a complete liquidation, §337 is not applicable to one-month liquidations under §333, supra page 651, to some liquidations of subsidiary corporations under §332, supra page 651, or to liquidations of "collapsible" corporations, infra page 687.

Does the pre-1954 dichotomy between selling-before-distributing and distributing-before-selling still hold sway in these areas?

4. *References.* Note, Tax-Free Sales in Liquidation Under Section 337, 76 Harv. L. Rev. 780 (1963); Pustilnik, Liquidations of Closely-Held Corporations Under Section 337, 16 Tax Law Rev. 255 (1961); Lyon and Eustice, Assignment of Income: Fruit and Tree as Irrigated by the P. G. Lake Case, 1962 So. Calif. Tax Inst. 47, 235-248.

UNITED STATES v. LYNCH

192 F.2d 718 (9th Cir. 1951), cert. denied, 343 U.S. 934 (1952)

Before MATHEWS, ORR and POPE, Circuit Judges.

ORR, Circuit Judge.

We have for determination two appeals. In the first the United States of America, hereinafter referred to as the Government, is appellant, and P. J. Lynch is appellee. In the second P. J. Lynch is appellant, and the United States of America is appellee.

We first consider the appeal of the Government. It concerns the correctness of a determination made by the Commissioner of Internal Revenue, that the net proceeds of profits from the sale of apples, which the Washington Fruit and Produce Company, a corporation, had attempted to distribute to its stockholders as a dividend in kind, was taxable to the corporation.

Lynch is one of several stockholders to whom a dividend in kind was issued by the Washington Fruit and Produce Company, a corporation, to which we hereinafter refer as the corporation. This dividend consisted of 21,977 boxes of apples. The corporation at that time had three stockholders and was engaged in the business of growing, handling, warehousing and marketing of fresh fruits and vegetables. The dividend in kind was declared February 28, 1944. The apples distributed as a dividend were on that date owned and held by the corporation in its warehouse. At the same meeting at which the dividend was declared, the shareholders agreed among themselves to pool the apples and entered into an agreement with the corporation to dispose of the apples and account to the shareholders for the net proceeds after deducting the costs of washing, packing and storing. During April 1944 the apples were sold and the proceeds distributed. Possession of the apples was retained by the corporation and the sale thereof accomplished without difficulty, the state of the market being such that solicitation by the corporation for buyers was unnecessary. On April 29, 1944 the corporation was liquidated. The Commissioner held that the excess of the sale price of the apples above cost to the corporation was corporate income. The trial court found otherwise. We think its finding was clearly erroneous for the following reasons: The dividend was not, nor was it intended to be, a liquidating dividend made in the process of winding up corporate affairs. The trial court found the dividend to be an ordinary one, reported as ordinary income by the recipients. The corporation continued to engage in its normal business for a period of two months after the dividend declaration. We are, therefore, required to regard the dividend under consideration here as one declared by a going concern and, inasmuch as the corporation, among other things, was engaged in the business of selling apples the property distributed represented its inventory or stock in trade.

It is clear that the shareholders caused the dividend to be declared with the knowledge and expectation that the property distributed would be sold imme-

diately. Furthermore, the simultaneously executed agreement with the corporation to do the selling manifested a purpose on the part of the shareholders to use the corporate agency as the vehicle to effectuate the sale of apples. The corporation was to sell the apples in the normal course of its business, in essentially the same manner, and it is fair to assume to the same persons to whom it would have sold had there been no dividend declared. Under these circumstances we fail to see a motive for the dividend other than to escape taxation. It is fundamental that,

> . . . in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.[1]

The dividend in question was not the kind of a distribution contemplated by [§301], and must be ignored for tax purposes. Distribution of corporate inventory with the expectation of immediate sale by the shareholders pointedly suggests a transaction outside the range of normal commercially-motivated and justifiable corporate activity, yet we have here a stronger case, because the sale was to be made by utilizing the corporation's facilities in the ordinary course of its business; the shareholders did not engage in a separate and independent business in which the apples were to be used. The shareholders, under the circumstances of this case, cannot avoid payment of the price Congress has decreed must be paid for use of the corporate entity.

In its opinion the trial court used language indicating its belief that the doctrine announced in Court Holding Co. v. C.I.R., 324 U.S. 331, required a finding in the instant case that the sale was made by the shareholders. The *Court Holding Company* case, as well as the case of Cumberland Public Service Co. v. U.S., 338 U.S. 451, dealt with liquidating dividends and not, as here, with a dividend in kind by a going concern. In the *Cumberland* case the Supreme Court points out that "The corporate tax is thus aimed primarily at the profits of a going concern." Hence, in determining the "factual category" in which the present transaction belongs the factor of the going concern is most important. In the instant case, at the time the transaction was planned and executed all concerned knew that no necessity existed for the corporation to engage in prior negotiations and solicitations for sale of the apples because of available ready market. The record discloses that the corporation gave the shareholders most favored customer treatment by not charging a selling commission and, in addition, certain customary handling charges were not imposed. These circumstances constitute grounds for attributing the sale to the corporation. . . .

NOTE

1. *Implications of the Lynch case.* Does this decision imply that a sale of inventory property is always to be imputed to the distributing corporation? If not, what criteria determine when imputation is proper? If the corporation had been liquidated in February (when the apples were distributed), rather than two months later, would the tax result have been different?

2. *Relation of Lynch case to §337.* If §337 had been in force for the taxable year in *Lynch,* gain on corporate sales of the apples in the ordinary course of business would not have qualified for non-recognition because of §337(b)(1)(A). If the corporation had sold the entire crop to the partnership in one transaction after adopting a plan of complete

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[1] C.I.R. v. Transport Trading & Terminal Corp., 2 Cir., 1949, 176 F.2d 570, 572, certiorari denied, 338 U.S. 955.

liquidation, would §337(b)(1)(B) confer immunity on the corporation's gain? On attempts to employ §337 for sales to insiders, see Rev. Rul. 61-156, page 717 infra.

Section H. The "Collapsible" Corporation

Section 341, relating to collapsible corporations, was based on §117(m) of the 1939 Code. The principal changes are the definition of "§341 assets" and the presumption of §341(c) — both enacted in 1954 — and the escape hatch of §341(e), enacted in 1958.

BRAUNSTEIN v. COMMISSIONER

374 U.S. 65 (1963)

Mr. Justice Harlan delivered the opinion of the Court.

This case involves the applicability of the "collapsible corporation" provisions of the federal income tax laws which, during the period relevant here, were set forth in [§341(a)-(d)]. These provisions require that under certain circumstances, gain from the sale of stock which would otherwise be considered as long-term capital gain, and accordingly taxed at a maximum rate of 25%, must be reported as ordinary income.

The three taxpayers who are petitioners here became associated in 1938 and have since participated in a number of construction projects, usually through corporations in which the stock was equally divided. In 1948 the petitioners received a commitment from the Federal Housing Administration to insure loans for the construction of a multiple-dwelling apartment project in Queens County, New York. Two corporations were formed to carry out this project, and each petitioner was issued one-third of the stock in each corporation. After the costs of construction had been paid, the corporations each had an unused amount of mortgage loan funds remaining, and in 1950 the petitioners sold their stock at a profit, receiving as part of the sale transaction distributions from the corporations which included the unused funds. The petitioners reported the excess of the amounts received over their bases in the stock as long-term capital gains of $313,854.17 each.[1]

The Commissioner asserted a deficiency, treating the gain as ordinary income on the ground that the corporations were "collapsible" within the meaning of [§341(a)]. The Tax Court sustained the Commissioner, 36 T.C. 22, and the Court of Appeals affirmed the Tax Court, 305 F.2d 949, holding that (1) the taxpayers had the requisite "view" during construction of the property; (2) more than 70% of the gain realized by the taxpayers was attributable to the constructed property; and (3) [§341(a)] applies even if the constructed buildings would have produced capital gain on a sale by the taxpayers had no corporations been formed. This last holding was in response to an argument by the taxpayers based on a theory similar to that adopted by the Court of Appeals for the Fifth Circuit in United States v. Ivey, 294 F.2d 799. In view of the conflict between the decision below and that in *Ivey* on this point, we granted certiorari, 371 U.S. 933, stating that the grant was limited to the following question:

> Whether [§341(a)], which provides that gain "from the sale or exchange . . . of stock of a collapsible corporation" is taxable as ordinary income rather than capital gain, is inapplicable in circumstances where the stockholders would have been entitled to capital

[1] The parties have agreed that the distributions from the corporations and the amounts received directly from the buyers of the stock may be considered together, as if the entire amount had been received from the buyers.

gains treatment had they conducted the enterprise in their individual capacities without utilizing a corporation.

Briefly summarized, petitioners' argument runs as follows. As the legislative history shows, the collapsible corporation provisions of the code were designed to close a loophole through which some persons had been able to convert ordinary income into long-term capital gain by use of the corporate form. For example, in the case of an individual who constructed a property which he held primarily for sale to customers in the ordinary course of his trade or business, any gain from the sale of the asset would be ordinary income; but if that same individual were to form a corporation to construct the property, intending to sell his stock on the completion of construction it was at least arguable prior to the enactment of [§341] that the proceeds of the ultimate sale of the stock were entitled to capital gains treatment.* It was this and similar devices that [§341] was designed to frustrate, but it was *not* intended to have the inequitable effect of converting into ordinary income what would properly have been a capital gain prior to its enactment even in the absence of any corporate form. Thus, it is argued, the phrase "gain attributable to such property," as used in [§341(a)], must apply only to profit that would have constituted ordinary income if a corporation had not been utilized, for only in such cases is the corporation made to serve as a device for tax avoidance. In the present case, neither the corporation nor the individual petitioners were in the trade or business of selling apartment buildings, and thus the corporations were not used to convert ordinary income into capital gain and the provisions of [§341] are inapplicable.[2]

We have concluded that petitioners' contentions must be rejected. Their argument is wholly inconsistent with the plain meaning of the language of [§341], and we find nothing in the purpose of the statute, as indicated by its legislative history, to warrant any departure from that meaning in this case.

I

As to the language used, [§341(a)] defines a collapsible corporation as embracing one formed or availed of principally for the manufacture, construction, or production of property with a view to (1) the sale or exchange of stock prior to the realization by the corporation of a substantial part of the net income from the property *and* (2) the realization "of gain attributable to such property." The section

* Another possibility: a motion picture producer and the leading performers organize a corporation to manufacture and market a single film. They invest nominal amounts, receiving the corporation's stock in return, and the corporation borrows enough to defray the costs of production. Since the producer and the key performers receive modest salaries, if any, the costs of production are appreciably less than normal. After the picture has been completed, contracts for its distribution are made by the corporation. Then the corporation is liquidated, the shareholders surrendering their stock in exchange for proportionate interests in the distribution contracts. Since §331(a)(1) provides that a complete liquidation shall be treated as a sale, the shareholders report the difference between the value of the contracts (estimated from the film's early reception) and the cost basis of the shares as long-term capital gain. The value reported for the shareholder's rights under the contract is then depreciated over the estimated commercial life of the film. If the net receipts correspond to the reported value, there will be no further gain or loss. If, however, the receipts depart from the estimate, the shareholder will realize income or loss in the amount of the difference.

With the enactment of §341, the liquidation of such a corporation (if it is found to be collapsible) will produce ordinary income to the shareholders, rather than long-term capital gain. — Ed.

2 The Government has assumed for purposes of its argument here, but does not concede, that petitioners would have been entitled to capital-gains treatment had they conducted the enterprise without utilizing a corporation.

is then expressly made inapplicable to gain realized during any year "unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced." [§341(d)(2).] If used in their ordinary meaning, the word "gain" in these contexts simply refers to the excess of proceeds over cost or basis and the phrase "attributable to" merely confines consideration to that gain caused or generated by the property in question. With these definitions, the section makes eminent sense, since the terms operate to limit its application to cases in which the corporation was availed of with a view to profiting from the constructed property by a sale or exchange of stock soon after completion of construction *and* in which a substantial part of the profit from the sale or exchange of stock in a given year was in fact generated by such property.

There is nothing in the language or structure of the section to demand or even justify reading into these provisions the *additional* requirement that the taxpayer must in fact have been using the corporate form as a device to convert ordinary income into capital gain. If a corporation owns but one asset, and the shareholders sell their stock at a profit resulting from an increase in the value of the asset, they have "gain attributable to" that asset in the natural meaning of the phrase regardless of their desire, or lack of desire, to avoid the bite of federal income taxes.

II

Nor is there anything in the legislative history that would lead us to depart from the plain meaning of the statute as petitioners would have us do. There can of course be no question that the purpose of [§341] was, as petitioners contend, to close a loophole that Congress feared could be used to convert ordinary income into capital gain. See H.R. Rep. No. 2319, 81st Cong., 2d Sess.; S. Rep. No. 2375, 81st Cong., 2d Sess. But the crucial point for present purposes is that the *method* chosen to close this loophole was to establish a carefully and elaborately defined category of transactions in which what might otherwise be a capital gain would have to be treated as ordinary income. There is no indication whatever of any congressional desire to have the Commissioner or the courts make a determination in each case as to whether the use of the corporation was for tax avoidance. Indeed, the drawing of certain arbitrary lines not here involved — such as making the section inapplicable to any shareholder owning 10% or less of the stock or to any gain realized more than three years after the completion of construction* — tends to refute any such indication. It is our understanding, in other words, that Congress intended to define what it believed to be a tax avoidance device rather than to leave the presence or absence of tax avoidance elements for decision on a case-to-case basis.

We are reinforced in this conclusion by the practical difficulties — indeed the impossibilities — of considering without more legislative guidance than is furnished by [§341] whether there has in fact been "conversion" of ordinary income into capital gains in a particular case. For example, if we were to inquire whether or not the profit would have been ordinary income had an enterprise been individually owned, would we treat each taxpaying shareholder differently and look only to *his* trade or business or would we consider the matter in terms of the

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* For the taxable year before the court in *Braunstein*, persons owning not more than 10 per cent of the corporation's stock could, if they met certain other requirements, escape the impact of §341. This escape hatch is now open only to taxpayers owning not more than 5 per cent of the stock. See §341(d)(1).

See also §341(d)(3), providing an escape from §341 in the case of gain realized more than 3 years after completion of the construction, manufacture, etc. of the collapsible property. — Ed.

trade or business of *any* or at least a substantial number of the shareholders? There is simply no basis in the statute for a judicial resolution of this question, and indeed when Congress addressed itself to the problem in 1958, it approved an intricate formulation [§341(e)] falling between these two extremes.

As a further example, what if the individual in question is not himself engaged in any trade or business but owns stock in varying amounts in a number of corporate ventures other than the one before the court? Do we pierce *each* of the corporate veils, regardless of the extent and share of the individual's investment, and charge him with being in the trade or business of each such corporation? Again, there is no basis for a rational judicial answer; the judgment is essentially a legislative one and in the 1958 amendments Congress enacted a specific provision [§341(e)], designed to deal with this matter, that is far too complex to be summarized here.

These examples should suffice to demonstrate the point: The question whether there has in fact been a "conversion" of ordinary income in a particular case is far easier to state than to answer, and involves a number of thorny issues that may not appear on the surface.[3] We find no basis in either the terms or the history of [§341] for concluding that Congress intended the Commissioner and the courts to enter this thicket and to arrive at *ad hoc* determinations for every taxpayer. Accordingly, the judgment below must be affirmed.

MR. JUSTICE DOUGLAS dissents.

NOTE

1. *Definition of "collapsible corporation."* A "collapsible corporation," as the term is defined by §341(b)(1), must be formed or availed of:

(a) principally for the manufacture, construction, or production of property, for the purchase of certain categories of property (primarily property held for sale to customers in the ordinary course of its trade or business), or for the holding of stock in another corporation so formed or availed,

(b) with a view to (1) a sale or exchange of its stock, or a distribution to its shareholders, before it has realized a substantial part of the taxable income to be derived from the manufactured or purchased property, and (2) a realization by the shareholders of gain attributable to the property.

Requirement (a) is satisfied by a great many corporations, especially since the concept of "manufacture, construction, or production of property" is defined very expansively. Regs. §1.341-2(a)(5); Farber v. Commissioner, 312 F.2d 729 (2d Cir. 1963). Query: can a personal service firm be considered a collapsible corporation on the ground that it was formed or availed of for the "production of property," viz., goodwill?

Most of the litigation concerning the definition of "collapsible corporation" has turned on whether requirement (b) was satisfied, i.e., whether the shareholders had the requisite "view." In the *Braunstein* case, the shareholders asserted that the corporations were formed to accumulate substantial estates for their families, and that the distributions and sales were attributable to an unanticipated decline in the profits generated by the buildings after construction was completed. The Tax Court rejected these contentions, finding that the shareholders contemplated a quick profit that was not dependent on continued ownership of the buildings; the Court of Appeals for the Second Circuit affirmed, and the Supreme Court's grant of certiorari excluded this issue. 36 T.C. 22; 305 F.2d 949. The Regulations speak of a "view" that exists before the manufacture, construction, production, or purchase of property is completed, and are willing to overlook a subsequently

[3] The Government has emphasized in its argument here that the present case involves a particularly "blatant" conversion of ordinary income because by charging the corporations only for the out-of-pocket costs of construction "petitioners contributed their services to create a valuable property for the corporation[s] and then realized upon that value by selling their stock." Thus, the Government concludes, the petitioners claim as capital gain "what ought to have been (and, in an arm's-length transaction, would have been) taxed as compensation for services."

conceived "view," at least in ordinary circumstances. Regs. §1.341-2(a)(3). This approach has led to a few shareholder victories; see Jacobson v. Commissioner, 281 F.2d 703 (3d Cir. 1960) (sale not contemplated until after construction was completed; held, not collapsible); Temkin v. Commissioner, 35 T.C. 906 (1961) (sale attributable to ill health of a principal shareholder, arising after construction was completed; held, not collapsible). Several courts have suggested that the Regulations are too complaisant, however, and that even a post-construction "view" meets the statutory requirement. If the statute is construed this broadly, is the "view" ipso facto present whenever a sale, liquidation, or distribution precedes substantial realization of the income? See Farber v. Commissioner, 312 F.2d 729 (2d Cir. 1963), and cases there cited.

When §341 was first enacted, the commentators engaged in a lively debate over the referent of the adverb "principally" in §341(b)(1). In Weil v. Commissioner, 252 F.2d 805 (2d Cir. 1958), the court said that "principally" modifies only "manufacture, construction," etc., and that the "view" need not be "the principal corporate objective." Although the *Weil* case has gained a large measure of support, no court has as yet worked out the implications of the statement in the Regulations that the "view" requirement is satisfied even if a sale, liquidation, etc. is no more than "a recognized possibility." Regs. §1.341-2(a)(2).

2. *Realization of "substantial part" of taxable income.* If the shareholders *intend* to liquidate the corporation before it has realized "a substantial part of the taxable income to be derived from [the collapsible] corporation," but *in point of fact* the corporation is not liquidated until after all the taxable income has been realized, is §341 applicable? Although the language of §341(b)(1)(A) implies that the "view" rather than the fact is controlling, the Regulations adopt a contrary position — if the income is realized, we are to forgive and forget the tainted purpose. Regs. §1.341-5(c)(2).

Is the corporation collapsible if it has realized a substantial part of the income to be derived from the collapsible property, but a substantial part remains to be realized when the sale or liquidation occurs? Compare Commissioner v. Kelley, 293 F.2d 904 (5th Cir. 1961) (corporation realized 33 per cent of potential income; held, not collapsible), with Abbott v. Commissioner. 258 F.2d 537 (3d Cir. 1958) ("substantial part" refers to amount to be realized, not amount already realized).

3. *The operative effects of §341.* If a corporation is collapsible, the shareholders (subject to certain exceptions) must report as ordinary income any gain from a sale or exchange of the stock, a distribution in partial or complete liquidation, or a non-dividend distribution under §301(c)(3)(A) that would otherwise be reported as long-term capital gain. In the *Braunstein* case, the gain realized by the shareholders was composed partly of a non-dividend distribution under §301(c)(3)(A) and partly of profit on the sale of their shares; both would have been long-term capital gain had §341 been inapplicable. Although §341(a) does not explicitly mention long-term capital gain on a redemption of shares, it may be that redemptions are embraced by the reference to a "sale" of stock in §341(a)(1). Section 341 does not transform short-term capital gain into ordinary income, and it has no impact if the shareholders incur a loss on the transaction.

Collapsible corporations are disqualified by §337(c)(1) from using §337 to avoid recognition of gain on a sale of property. Were it not for this limitation, a corporation could avoid recognition of gain on a sale of its assets under §337 and the shareholders could avoid §341 on the ground that the sale constituted a "realization" by the corporation of its gain (even though no corporate tax was payable because the gain was not "recognized") that made the corporation non-collapsible. By selling its assets and recognizing its gain, however, an otherwise collapsible corporation will take itself out of the collapsible category — see Regs. §1.341-5(c)(2) — with the result that the tax at the corporate level will permit the taxpayers to report their profit on the liquidation as capital gain.

4. *Minority shareholders.* In determining whether the forbidden "view" exists, the Regulations look to "those persons in a position to determine the policies of the corporation, whether by reason of their owning a majority of the voting stock of the corporation or not." Regs. §1.341-2(a)(2). Since the punitive rules of §341(a) apply to all shareholders of a collapsible corporation, a minority shareholder cannot escape by showing that he did not share in the forbidden "view." But if he is the only shareholder who sells his stock, the corporation may be non-collapsible because the dominant shareholders did not intend

to sell *their* shares before a substantial part of the income was realized by the corporation. See Goodwin v. United States, 320 F.2d 356 (Ct. Cl. 1963).

Regardless of his "view," however, a person who owns (directly or constructively) no more than 5 per cent of the collapsible corporation's stock may be able to avail himself of the exception of §341(d)(1).

5. *The limitations of §341(d).* By virtue of §341(d), §341 is inapplicable to gain realized more than three years after the construction, etc., is completed, to gain recognized during a taxable year unless more than 70 per cent of it was attributable to the collapsible property, or, if certain conditions are satisfied, to persons owning not more than 5 per cent of the corporation's stock. The three-year rule is difficult to satisfy in view of the broad meaning given to "manufacture, construction, or production," and the 5 per cent rule is limited in its usefulness because of the constructive ownership rules of §341(d) (last sentence). The 70 per cent rule may be significant if the corporation holds both collapsible and non-collapsible property; if enough of the gain is attributable to the latter category, the gain attributable to the collapsible property slips through unscathed by §341. When the corporation's principal or only asset is real estate on which it has constructed a building, however, shareholders have not been very successful in establishing that 30 per cent or more of their gain was of the non-collapsible variety. See Farber v. Commissioner, supra page 687, and cases there cited. In *Braunstein,* this escape was held inapplicable by the Tax Court and the Court of Appeals; their determination on this issue was not reviewed by the Supreme Court.

6. *Distributions of "excess" mortgage proceeds by collapsible corporations.* Much of the §341 litigation has concerned corporations (as in *Braunstein*) which constructed apartment houses or other buildings under the Federal Housing Act and were able to borrow, on federally insured mortgages, more than the cost of construction. This excess of the mortgage loan over the corporation's cost might be attributable to construction economies, to inflation in the value of previously acquired land, to overly generous appraisals by the federal authorities, to the uncompensated personal efforts of the shareholders (see footnote 3 of the *Braunstein* opinion), or to the unlawful substitution of shoddy materials for those specified in the contract on which the government's appraisal was based. Before 1954, it was common (as in *Braunstein*) for such excess mortgage proceeds to be distributed to shareholders before the corporation had any earnings and profits (so the distribution would not be a taxable dividend). In Commissioner v. Gross, 236 F.2d 612 (2d Cir. 1956), it was held that such a distribution was to be applied against the shareholder's basis for his stock, and that any excess over his basis was capital gain under §301(c)(3)(A). This result was changed (prospectively only) by the enactment in 1954 of §312(j), under which a distribution creates earnings and profits if the corporation's assets are subject to a loan that was made, guaranteed, or insured by the United States and that exceeds the adjusted basis of the mortgaged property. A distribution in these circumstances, therefore, will be a taxable dividend to the shareholders.

Section 312(j) did not make §341 unnecessary as to such construction companies, however, because §312(j) does not apply if the shareholders realize on the excess mortgage money by selling their stock rather than by causing the corporation to distribute the funds to them.

7. *The amnesty of §341(e).* Section 341(e), inapplicable to the taxable year before the Supreme Court in the *Braunstein* case (1950), was enacted in 1958 in recognition of the fact that §341 not only prevents some taxpayers from transmuting potential ordinary income into capital gain, but also forces others to report as ordinary income a gain that would have been taxed as capital gain if realized without the intervention of a corporation. But §341(e) accomplishes its intended purpose in remarkably labyrinthian fashion, and its involutions are not easily summarized. Roughly speaking, its underlying theory is that the collapsible corporation provisions should not be applied if the net unrealized appreciation in the corporation's "subsection (e) assets" (property that would produce ordinary income if sold by the corporation or by its principal shareholders) amounts to less than 15 per cent of the corporation's net worth. As the *Braunstein* opinion indicates, §341(e) looks not only to the corporation's trade or business in determining whether property constitutes a "subsection (e) asset," but also to the trade or business of the corporation's principal shareholders (those owning, directly or constructively, more than 20 — sometimes 5 — per cent of the stock); and sometimes §341(e) takes account of a hypo-

thetical trade or business that is imputed to a shareholder because of the activities of other corporations in which he owned stock in the past, directly or constructively. Section 341(e) not only contains provisions to protect the shareholder of an otherwise collapsible corporation against the rules of §341(a), but also permits the corporation, on meeting certain conditions, to make use of §337 on a sale of its assets.

Since two of the principal shareholders in the *Braunstein* case had been engaged in the real estate construction business for many years, directly or through other corporations (36 T.C. 22, 23), they might not have qualified for relief under §341(e) even if it had been in force in 1950. If they had been investors in real estate, with no interests in other corporations, however, and if the buildings were held by the corporations for rental purposes, §341(e)(1) would have been applicable: the buildings would not be "subsection (e) assets" and hence none of the corporations' net worth would have been attributable to unrealized appreciation in such assets, with the result that the corporations (regardless of the shareholders' "view") would not be collapsible.

8. *Non-statutory attacks on collapsible corporations.* Was §341 necessary? When it was enacted, the Congressional committees stated that "no inference shall be drawn from the amendment with respect to gains realized prior to 1950." H.R. Rept. No. 2319 and S. Rept. No. 2375, 81st Cong. 2d Sess., 1950-2 C.B. 380, 451, 516. Could the collapsible corporation have been assailed successfully with such weapons as Commissioner v. Laughton, supra page 401; Lucas v. Earl, supra page 343; Higgins v. Smith, 308 U.S. 473 (1940); and Griffiths v. Helvering, 308 U.S. 355 (1940)? See Bittker and Redlich, Corporate Liquidations and the Income Tax, 5 Tax L. Rev. 437, 437-448 (1950).

In the first pre-§341 case of an attempt by the Treasury to disregard the liquidation of a collapsed corporation, it lost. Herbert v. Riddell, 103 F. Supp. 369 (S.D. Cal. 1952). There, however, the court found that the stockholders did not intend to collapse the corporation when they organized it; the liquidation was decided upon subsequently, as a result of a difference of opinion among its stockholders as to future business policy. See also O'Brien v. Commissioner, 25 T.C. 376 (1955), following Herbert v. Riddell, although there was evidently no showing that the shareholders intended to make more than a single motion picture. In Jacobs v. Commissioner, 224 F.2d 412 (9th Cir. 1955), however, a corporation organized to enable the owner of appreciated inventory property to sell it for a capital gain (by transferring the property to the corporation and selling its stock) was disregarded, and the transaction was treated as a sale of the property itself rather than the stock. The taxable year antedated the enactment of §341(b)(3), which permits inventory property to be treated as "collapsible" property in applying §341.

9. *References.* Axelrad, Collapsible Corporations and Collapsible Partnerships, 1960 So. Calif. Tax Inst. 269, is an exhaustive study of §341, which cites the principal earlier literature; Nordberg, "Collapsible" Corporations and the "View," 40 Taxes 372 (1962); Boland, Collapsible Corporations Under the 1958 Amendments, 17 Tax L. Rev. 203 (1962).

Section I. Stock Dividends and Recapitalizations

1. *Stock Dividends*

Section 305(a) of the 1954 Code, relating to distributions by a corporation of its own stock, substantially changes §115(f)(1) of the 1939 Code.

Section 305(b)(1), relating to distributions of stock in discharge of preference dividends, has no counterpart in the 1939 Code.

Section 305(b)(2), relating to elective distributions of stock, is derived from §115(f)(2) of the 1939 Code.

Section 307(a) of the 1954 Code, relating to the basis of stock received tax-free, is derived from §113(a)(19) of the 1939 Code.

Section 307(b) of the 1954 Code, relating to the basis of certain stock rights, has no counterpart in the 1939 Code.

The federal income tax treatment of distributions by a corporation of its own stock (and of rights to acquire its own stock) can be divided into five eras:

1. *1913-1916.* The Revenue Act of 1913 said nothing about stock dividends. Despite this omission, the Treasury sought to tax stock dividends under the catchall language of §22(a) of pre-1954 law, now §61(a). The Treasury position was upheld in Towne v. Eisner, 242 Fed. 702 (S.D.N.Y. 1917), but this decision was reversed by the Supreme Court, 245 U.S. 418 (1918), on the ground that a stock dividend was not "income" as that term was used in the statute. The Court also said that "it is not necessarily true that income means the same thing in the Constitution and the [Revenue] Act." This suggested that the Court was not passing on the constitutionality of an explicit provision taxing stock dividends.

2. *1916-1921.* The Revenue Act of 1916 taxed all stock dividends (if covered by post-1913 earnings and profits). In Eisner v. Macomber, supra page 56, this provision was held unconstitutional as applied to a distribution of common stock on common stock by a corporation having no other class of stock outstanding. Eisner v. Macomber should be reviewed at this point.

3. *1921-1938.* In response to Eisner v. Macomber, Congress provided in the Revenue Act of 1921 that "a stock dividend shall not be subject to tax," and this provision was carried forward until the enactment of the Revenue Act of 1936.

During this period the Treasury's Regulations required the adjusted basis of the old stock to be allocated between the old shares and the dividend shares in proportion to their respective market values at the time of distribution. In Koshland v. Helvering, 298 U.S. 441 (1936), this regulation was held invalid as to a taxpayer who had received a dividend of common stock on non-voting preferred shares. No such distribution was made on the common stock. The Court reasoned that the dividend shares, unlike those in Eisner v. Macomber, gave "the stockholder an interest different from that which his former stockholdings represented." Therefore, said the Court, the shares were constitutionally taxable when received. The Court then held that the failure of Congress to tax the dividend shares did not authorize the Treasury to allocate part of the basis of the old shares to the dividend shares. Consequently the old shares retained their full basis for determining gain or loss on their disposition.

Besides making clear that Eisner v. Macomber did not immunize all stock dividends, the *Koshland* case opened up the possibility of an escape from taxation for taxpayers who had accepted the benefit of the regulation in question by allocating part of their original basis to the dividend shares on sales of those shares. It was possible that such taxpayers could claim the full original basis on a later sale of the original shares. Not long after the *Koshland* case, the Court held in Helvering v. Gowran, 302 U.S. 238 (1937), that under the 1921-1936 statutes the basis of dividend shares was zero, since they cost the stockholder nothing and were not taxed as income when received. This determination opened up the possibility — the converse of the possible escape from taxation under the *Koshland* case — that a taxpayer who had complied with the invalidated regulation on selling his original shares (by allocating part of their basis to the retained dividend shares) would now have to use a zero basis on selling the dividend shares, and thus would never recover tax-free his total investment.

To counteract these possible results of the *Koshland* and *Gowran* cases, Congress in 1939 enacted §113(a)(19) of the 1939 Code, the predecessor of §307(a) of the 1954 Code. It adopted the rules applied under the invalidated Treasury regulation and also made provision for situations in which income on the sale of either the original or the dividend shares had been computed in a fashion inconsistent with the old regulation. Alvord and Biegel, Basis Provisions for Stock Dividends Under the 1939 Revenue Act, 49 Yale L.J. 841 (1940). At the same time, Congress provided that the "holding period" of non-taxable shares includes the period during which the original shares were held. This provision is now §1223(5).

4. *1936-1954.* In response to the *Koshland* case, supra, holding that some stock dividends were constitutionally subject to tax, Congress provided in §115(f)(1) of the Revenue Act of 1936 that:

A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

Did this section tender the Supreme Court an opportunity to re-examine Eisner v. Macomber or did it take that case as its starting point? In Helvering v. Griffiths, 318 U.S. 371 (1943), a majority of the Court held that §115(f)(1) was not intended to invite a reconsideration of Eisner v. Macomber; the minority saw such an invitation, accepted it, and expressed the view that Eisner v. Macomber should be overruled. As §115(f)(1) was interpreted by the majority, then, "the tax status of a stock dividend now [pre-1954] turns in effect on what would have been unconstitutional under Eisner v. Macomber if Eisner v. Macomber had been correct in its premise that a constitutional issue is present.' ' Cohen, Surrey, Tarleau, and Warren, A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Stockholders, 52 Colum. L. Rev. 1, 9-10 (1952).

Just what stock dividends could be taxed under §115(f)(1) of the 1939 Code, as thus construed, was veiled with obscurity. In Strassburger v. Commissioner, 318 U.S. 604 (1943), the Supreme Court held (by a 5-to-3 vote) that a distribution of a newly created issue of non-voting cumulative preferred stock by a corporation that had only common stock outstanding was not taxable. All of the common stock was owned by a single stockholder, the taxpayer. The Court said:

While the petitioner . . . received a dividend in preferred stock, the distribution brought about no change whatever in his interest in the corporation. Both before and after the event he owned exactly the same interest in the net value of the corporation as before. At both times he owned it all and retained all the incidents of ownership he had enjoyed before. [318 U.S. at p. 607.]

In Helvering v. Sprouse, decided at the same time as the *Strassburger* case, the Court held that a distribution of non-voting common stock by a corporation having both voting and non-voting common outstanding was also non-taxable. The non-voting common was distributed to the holders of both the voting and the non-voting common, but the taxpayer, before the stock dividend, owned only voting common. The government argued that the distribution came within the rule of the *Koshland* case that "where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented he receives income." But the Court (5-to-3) said:

We think Koshland v. Helvering, 298 U.S. 441, distinguishable. That was a case where there were both preferred and common stockholders and where a dividend in common was paid on the preferred. We held, in the circumstances there disclosed, that the dividend was income but we did not hold that any change whatsoever in the character of the shares issued as dividends resulted in the receipt of income. On the contrary the decision was that, to render the dividend taxable as income, there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest. [318 U.S. at pp. 607, 608.]

Two other pre-1954 decisions that are worthy of note are Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951), cert. denied, 343 U.S. 901 (1952), and Wiegand v. Commissioner, 194 F.2d 479 (3d Cir. 1952); see also Lowndes, The Taxation of Stock Dividends and Stock Rights, 96 U. of Pa. L. Rev. 147 (1947); Rottschaefer, Present Taxable Status of Stock Dividends in Federal Law, 28

Minn. L. Rev. 106 and 163 (1944); Schmitt v. Commissioner, 208 F.2d 819 (3d Cir. 1954).

5. *1954.* Section 305(a) of the 1954 Code reinstates the 1921-1936 rule that distributions by a corporation of its own stock or of rights to acquire its own stock are not taxable. See, however, the limitations of §305(b). The corresponding basis provision, §307(a), continues the method of allocation first established by the Treasury regulation that was invalidated by the *Koshland* case and reinstated by §113(a)(19) of the 1939 Code. An exception, to avoid trifling basis adjustments when stock rights are received, is provided by §307(b). Where stock rights take over (either by election under §307(b)(2) or because §307(b)(1)(B) is not satisfied) part of the basis of the stock with respect to which they are distributed, upon exercise their basis will be added to the cost of the stock thus acquired in determining its basis. If stock rights with a basis are allowed to lapse without exercise, the Treasury takes the position that no loss is incurred, and that the shares in respect to which the rights were issued reacquire their original basis.

By virtue of §312(d), a non-taxable distribution of stock does not reduce the earnings and profits of the distributing corporation. Moreover, under §312(f)(2), if a corporation receives a non-taxable stock distribution from another corporation, the recipient corporation's earnings and profits are not increased thereby. Section 1223(5) provides that the holding period for non-taxable stock dividends and rights includes the period during which the taxpayer held the stock on which the dividend stock or rights were received; and §1223(6) provides that the holding period for stock purchased by the exercise of rights commences on the date the right was exercised.

See generally Bittker, Stock Dividends, Distributions in Kind, Redemptions, and Liquidations Under the 1954 Code, 1955 So. Calif. Tax Inst. 349; Whiteside, Income Tax Consequences of Distributions of Stock Rights to Shareholders, 66 Yale L.J. 1016 (1957).

CHAMBERLIN v. COMMISSIONER

207 F.2d 462 (6th Cir. 1953), cert. denied, 347 U.S. 918 (1954)

Before SIMONS, Chief Judge, and MCALLISTER and MILLER, Circuit Judges.

MILLER, Circuit Judge.

Petitioner C. P. Chamberlin seeks a review of an income tax deficiency determined by the Respondent for the calendar year 1946, and sustained by the Tax Court. In the Tax Court the proceeding was consolidated with the proceedings of five other taxpayers similarly situated, all of which proceedings involved the same factual and legal questions. The taxpayers, all of whom were stockholders of Metal Moulding Corporation, about which this litigation centers, and their respective deficiencies were as follows:

C. P. Chamberlin	$343,650.86
Grace A. Chamberlin, his wife	63,225.55
John H. Toner	19,620.37
Benjamin James Carl	7,244.29
Guy V. Schrock	9,177.83
Robert and Josephine Pierce	14,635.19

The Tax Court upheld the deficiency assessment in each proceeding. . . .

The facts in the main are stipulated and are not in dispute. . . .

The Metal Moulding Corporation, hereinafter referred to as the Corporation, is a Michigan corporation engaged in the business of manufacturing metal mouldings and bright work trim used in the manufacture of automobiles. . . . From

1940 until December 20, 1946, the issued and outstanding common stock totaled 1,002½ shares, of which Chamberlin and his wife together owned 83.8%. . . .

The business of the Corporation prospered, and after paying substantial cash dividends over a period of years, its balance sheet at the end of the first six months in 1946 reflected total assets of $2,488,836.53 and included in current assets $722,-404.56 cash and $549,950 United States Government Bonds and notes.

On December 16, 1946, the Corporation's authorized capital stock was increased from $150,000 to $650,000, represented by 6,500 shares of $100 par value common stock. On December 20, 1946, a stock dividend was declared and distributed of five shares of common for each share of common outstanding, and the Corporation's accounts were adjusted by transferring $501,250 from earned surplus to capital account.

On December 26, 1946, the articles of incorporation were amended so as to authorize, in addition to the 6,500 shares of common stock, 8,020 shares of 4½% cumulative $100 par value preferred stock. On December 28, 1946, a stock dividend was declared of 1⅓ shares of the newly authorized preferred stock for each share of common stock outstanding, to be issued pro rata to the holders of common stock as of December 27, 1946, and the Company's accounts were adjusted by transferring $802,000 from earned surplus to capital account. The preferred stock was issued to the stockholders on the same day. Prior to the declaration of the preferred stock dividend, the Corporation at all times had only one class of stock outstanding.

On December 30, 1946, as the result of prior negotiations hereinafter referred to, all of the holders of the preferred stock, except the estate of Edward W. Smith, deceased, which owned 20 shares, signed a "Purchase Agreement," with the Northwestern Mutual Life Insurance Company and The Lincoln National Life Insurance Company, which instrument was also endorsed by the Corporation for the purpose of making certain representations, warranties and agreements. Under the "Purchase Agreement" 4,000 shares of the preferred stock was sold to each of the two insurance companies at a cash price of $100 per share plus accrued dividends from November 1st, 1946 to date of delivery. Pursuant to the "Purchase Agreement" the holders of the preferred stock, with the exception of the estate of Edward W. Smith, delivered their stock certificates endorsed in blank to agents of the two insurance companies, who transferred to C. P. Chamberlin as agent for the stockholders funds for the amount of the purchase price, which Chamberlin distributed to the stockholders in proportion to their interests by delivery of his personal checks. . . .

In the latter part of 1945, the Corporation's attorney and Chamberlin discussed with an investment firm in Chicago the possibility of selling an issue of preferred stock similar to the stock subsequently issued. The Corporation had such a large accumulated earned surplus it was fearful of being subjected to the surtax provided for by [§531], but at the same time Chamberlin, the majority stockholder, was not willing to have the Corporation distribute any substantial portion of its earned surplus as ordinary dividends because his individual income was taxable at high surtax rates. It was proposed that the issuance of a stock dividend to the stockholders and the sale of it by the stockholders would enable the stockholders to obtain accumulated earnings of the Corporation in the form of capital gains rather than as taxable dividends. The investment counselor contacted The Lincoln National Life Insurance Company of Fort Wayne, Indiana, and during October 1946, furnished the Insurance Company financial information relative to the Corporation. On November 7, 1946, a representative of the Insurance Company came to Detroit and made an inspection of the plant and properties of the Corporation. On November 20, 1946, The Lincoln National Life Insurance Com-

pany's finance committee approved the proposed issue and the purchase of one-half thereof. The Northwestern Mutual Life Insurance Company was contacted for the purpose of participating in the purchase of the preferred stock. It made a detailed investigation of the Corporation and of the terms and conditions of the proposed preferred stock issue, and about two weeks before December 30, 1946, its committee on investments approved the purchase of 4,000 shares of the preferred stock to be issued, and passed the matter over to its legal department for the conclusion of the transaction.

The preferred stock contained the following provisions among others: The holders were entitled to cumulative cash dividends at the rate of $4.50 per annum payable quarterly beginning November 1, 1946; the stock was subject to redemption on any quarterly dividend date in whole or in part at par plus specified premiums and accrued dividends; it was subject to mandatory retirement in amounts not exceeding 2,000 shares on May 1, 1948 and 1,000 on May 1st on each succeeding year, depending upon the Corporation's net earnings for the preceding year, until fully retired on May 1, 1954; in the event of certain defaults, in dividend payments or annual retirements, the holders were entitled to elect a majority of the directors; as long as any preferred shares remained outstanding the consent of the holders of at least 75% thereof was required to validate certain actions, including changing the articles of incorporation or capital structure, the sale of the company's property, or the incurrence of indebtedness for borrowed money in excess of a certain amount; the Corporation could not pay any cash dividend upon any stock junior to the preferred if there was any default in the payment of dividend upon and the annual retirements of the preferred, or if such dividend reduced the net working capital of the Corporation below an amount equal to 150% of the aggregate par value of all outstanding preferred, or $750,000, whichever amount was greater, or reduced the current assets of the Company to an amount less than 200% of current liabilities. These provisions had been discussed with the Lincoln National Life Insurance Company and some of them, at least, were included in order to satisfy the investment requirements of the two insurance companies.

No agreement of purchase and sale was entered into between any of the petitioners and either of the two insurance companies prior to the "Purchase Agreement" executed on December 30, 1946, but the stockholders and directors of the Corporation took the necessary actions to put the negotiated plan into effect, as hereinabove set out, only after the insurance companies certified their willingness to participate in the purchase, if, as, and when the preferred stock was issued on the terms and conditions prescribed by them and as set out in the Company's charter as amended on December 27, 1946. . . .

The Tax Court held that the issue of whether the stock dividend constituted income to the stockholders should be determined from a consideration of all the facts and circumstances surrounding the issuance of the dividend and not by a consideration limited to the characteristics of the stock declared as a dividend; that each case involving a stock dividend must be decided upon its own facts and circumstances as establishing whether the receipt of a particular kind of stock dividend was in fact taxable; that such a decision did not rest upon matters of form or nomenclature attending a stock dividend distribution but rather upon the real substance of the transaction involved; that disregarding the circumstances and terms of the issue it might be said that as a mater of form the stock dividend . . . fell within the *Strassburger* case [supra p. 691], but that considering the real substance of the transaction it was of the opinion that the stock dividend was not in good faith for any bona fide corporate business purpose, and that the attending circumstances and conditions under which it was issued made it the equivalent of a cash dividend distribution out of available earnings, thus con-

stituting ordinary taxable income in the amount of the value of the preferred shares received. The Court also said that the real purpose of the issuance of the preferred shares was concurrently to place them in the hands of others not then stockholders of the Corporation, thereby substantially altering the common stockholders' pre-existing proportionate interests in the Corporation's net assets and thereby creating an entirely new relationship amongst all the stockholders and the Corporation. One judge concurred in the result without separate opinion; one judge concurred in a separate opinion which did not concur in the reasoning of the majority opinion, and a third judge wrote a dissenting opinion.

In our opinion, the declaration and distribution of the preferred stock dividend, considered by itself, falls clearly within the principles established in Towne v. Eisner and Eisner v. Macomber [supra p. 56], and is controlled by the ruling in the *Strassburger* case. Accordingly, as a preliminary matter, we do not agree with the Tax Court's statement that the stock dividend is taxable because as a result of the dividend and immediate sale thereafter it substantially altered the common stockholders' pre-existing proportional interests in the Corporation's net assets. The sale to the insurance companies of course resulted in such a change, but the legal effect of the dividend with respect to rights in the corporate assets is determined at the time of its distribution, not by what the stockholders do with it after its receipt. . . .

Nor is there any question about the genuineness and unconditional character of the sale of the preferred stock by the stockholders who received it to the two insurance companies. The facts show conclusively that title passed irrevocably from the stockholders to the insurance companies, and that the sellers received in cash without restriction a full consideration, the adequacy of which respondent does not question. But respondent contends that the sale of the stock following immediately upon its receipt resulted in the stockholder acquiring cash instead of stock, thus making it a taxable dividend under Secs. 22(a) and 115(a), [1939] Internal Revenue Code. There are two answers to this contention.

A non-taxable stock dividend does not become a taxable cash dividend upon its sale by the recipient. On the contrary, it is a sale of a capital asset. Eisner v. Macomber, 252 U.S. 189; Miles v. Safe Deposit & Trust Co., 259 U.S. 247. The rulings in those cases make it clear that its character as a capital asset is in no way dependent upon how long it is held by the taxpayer before its sale. In none of the Supreme Court cases referred to above, dealing with the taxability of stock dividends, was the length of the holding period considered as a factor. Obviously, if the non-taxability of a stock dividend rests solely upon the principle that it does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holdings, the disposition of the stock dividend by the stockholder thereafter is not a factor in the determination. See also: Insull v. Commissioner, 7 Cir., 87 F.2d 648; Silas H. Burnham, 29 B.T.A. 605.

The foregoing conclusion is supported by [§1223(5)], which provides that for the purpose of determining whether a non-taxable stock dividend which has been sold is a long-term capital gain there shall be included in the holding period the period for which the taxpayer held the stock in the distributing corporation prior to the receipt of the stock dividend. This necessarily recognizes that a stock dividend will often be sold before the expiration of six months after its receipt, and makes no distinction between a stock dividend held one day or for any other period less than six months. . . .

The other answer to the contention is that although the stockholder *acquired* money in the final analysis, he did not *receive* either money or property *from* the corporation. Sec. 115(a), [1939] Revenue Code [1954 Code, §316(a)], in dealing with taxable dividends, defines a dividend as "any distribution *made by a corpora-*

tion to its shareholders, whether in money or in other property . . . out of its earnings or profits. . . ." (Emphasis added.) The money he received was received from the insurance companies. It was not a "distribution" by the corporation declaring the dividend, as required by the statute.

We come then to what in our opinion is the dominant and decisive issue in the case, namely, whether the stock dividend, which, by reason of its redemption feature, enabled the Corporation to ultimately distribute its earnings to its stockholders on a taxable basis materially lower than would have been the case by declaring and paying the usual cash dividend, was a bona fide one, one in substance as well as in form. . . .

It seems clear that it was an issue of stock in substance as well as in form. According to its terms, and in the absence of a finding that it was immediately or shortly thereafter redeemed at a premium, we assume that a large portion of it has remained outstanding over a period of years with some of it still unredeemed after nearly seven years. It has been in the hands of the investing public, free of any control by the corporation over its owners, whose enforceable rights with respect to operations of the corporation would not be waived or neglected. Substantial sums have been paid in dividends. The insurance companies bought it in the regular course of their business and have held it as approved investments. For the Court to now tell them that they have been holding a sham issue of stock would be most startling and disturbing news.

It also seems clear that the insurance companies were not purchasers in form only without acquiring any real interest in the property conveyed. The character of the transaction as a bona fide investment on the part of the insurance companies is not challenged by the respondent. The element of a formal conduit without any business interest is entirely lacking.

If the transaction lacks the good faith necessary to avoid the assessment it must be because of the redemption feature of the stock, which, in the final analysis, is what ultimately permitted the distribution of the corporate earnings and is the key factor in the over-all transaction. Redemption features are well known and often used in corporate financing. If the one in question was a reasonable one, not violative of the general principles of bona fide corporate financing, and acceptable to experienced bona fide investors familiar with investment fundamentals and the opportunities afforded by the investment market we fail to see how a court can properly classify the issue, by reason of the redemption feature, as lacking in good faith or as not being what it purports to be. The insurance companies, conservative, experienced investors, analyzed the stock issue very carefully, provisions were required to make it conform to sound investment requirements, and each of the two companies, acting independently of the other, purchased a very substantial amount in the regular course of their investment purchases. If the redemption feature was unreasonable or not in accord with generally accepted investment principles the stock would not have been approved as an investment and purchased by the two insurance companies. In our opinion, the redemption feature, qualified as it was with respect to premiums, amounts subject to redemption in each year, and the length of time the stock would be outstanding, together with the acceptance of the stock as an investment issue, did not destroy the bona fide quality of the issue. We cannot say that the preferred stock was not in fact what it purported to be, namely, an issue of stock in substance as well as in form.

Each case necessarily depends upon its own facts. The facts in this case show tax avoidance, and it is so conceded by petitioner. But they also show a series of legal transactions, no one of which is fictitious or so lacking in substance as to be anything different from what it purports to be. Unless we are to adopt the broad policy of holding taxable any series of transactions, the purpose and result of

which is the avoidance of taxes which would otherwise accrue if handled in a different way, regardless of the legality and realities of the component parts, the tax assessed by the Commissioner was successfully avoided in the present case. We do not construe the controlling decisions as having adopted that view. . . .

The judgment is reversed and the case remanded to the Tax Court for proceedings consistent with the views expressed herein.

NOTE

1. *The legislative response to the "preferred stock bail-out": §306.* Section 306 of the 1954 Code is aimed squarely at the *Chamberlin* type of preferred stock "bail-out." If distributed after §306 took effect, the preferred stock received as a dividend in the *Chamberlin* case would be "§306 stock" under §306(c)(1)(A) and §306(c)(2). As a consequence, a sale of the preferred stock by one of the stockholders would produce ordinary income under §306(a)(1) to the extent of its share of the corporation's earnings and profits at the time it was issued. In the *Chamberlin* case, the stock was worth $100 per share when issued, and this amount was fully covered by earnings and profits; therefore, on a sale of the stock the proceeds would be ordinary income up to $100, and the balance, if any, would be taxed as a capital gain to the extent that it exceeded the stock's adjusted basis. For examples, see Regs. §1.306-1(b)(2).

If "§306 stock" is not sold but is instead redeemed by the corporation, the redemption is to be treated like an ordinary distribution, so that ordinary income will be received to the extent of the corporation's earnings and profits at the time of redemption. The proceeds of a sale, on the other hand, will be ordinary income to the extent of the stock's ratable share of earnings and profits when it was issued, even though the corporation has no earnings and profits when the stock is sold; and if the corporation has earnings and profits at that time, they are not reduced despite the fact that the shareholder is required to report ordinary income on the sale. Thus, to revert to the *Chamberlin* case, the sale of "§306 stock" by the recipients would have been taxed as an ordinary dividend, but the corporation's earnings and profits account would not reflect this fact, and a subsequent distribution of the very earnings and profits that caused the preferred stock to be treated as "§306 stock" will also be taxed as ordinary income to the stockholders. If they had caused the corporation to redeem their "§306 stock," on the other hand, they would have realized ordinary income to the extent of earnings and profits at the time of redemption, but the corporate earnings and profits account would be reduced accordingly. Whether the stock is sold or redeemed, however, the adjusted basis of the "§306 stock" will often not be recovered. Compare the status of stock redeemed under §302(d), supra page 659; and see the remedy adopted by Regs. §1.306-1(b)(2).

It will be noted that §306 is applicable even if there is no pre-arranged plan to sell the stock or to cause its redemption.

2. *Exceptions to §306.* The draconic rules just described are modified by the exceptions of §306(b). If the shareholder disposes of his entire stock interest (determined by applying the constructive ownership rules of §318) under circumstances set out in §306(b)(1), he can avoid ordinary income treatment. A redemption of the "§306 stock" in partial or complete liquidation will also relieve him of the special rules of §306. With respect to this exception, §306(b)(2), the Senate Report states (p. 243):

> In the case of a partial liquidation your committee contemplates a contraction of the corporate business so that it is immaterial that the distribution in partial contraction is with respect to section 306 stock. A bona fide contraction of the corporate business is not considered a means of distributing corporate earnings to shareholders at capital gains rates.

See page 664 supra on the relation of the term "partial liquidation" to a corporate contraction. An exchange of "§306 stock" in a non-taxable transaction (such as a tax-free reorganization or a §1036 exchange) is also excepted from the general rule of §306(a), but the stock received on the exchange will ordinarily become "§306 stock"; and its disposition will be subject to the same rules that would have governed a disposition of the "§306 stock"

given up. Finally, §306(b)(4) excepts transactions where it is established to the satisfaction of the Secretary of the Treasury that tax avoidance was not a principal purpose. This exception includes "isolated dispositions of section 306 stock by minority stockholders who do not in the aggregate have control of the distributing corporation" (S. Rept., p. 243), as well as dispositions of "§306 stock" by stockholders who have previously disposed of, or who simultaneously dispose of, the stock on which the "§306 stock" was issued.

Note that common stock distributed on common stock is not "§306 stock." §306(c)(1)(A). Why not? What *is* "common stock"? See Rev. Rul. 57-132, 1957-1 C.B. 115.

A gift of "§306 stock" is not a disposition under §306(a), according to Rev. Rul. 57-328, 1957-2 C.B. 229, but the stock continues to be "tainted" in the hand of the donee, by virtue of §306(c)(1)(C). But if the donee is a tax-exempt organization, it will pay no tax on a sale or redemption of the "§306 stock." What if a taxpayer, owning all of the stock of a corporation, causes it to issue a preferred stock dividend, which he then donates to a tax-exempt organization in anticipation of an immediate redemption?

Note that preferred stock issued in a §351 transaction (unless issued in exchange for "§306 stock") is not "tainted." To what extent, if at all, can such preferred stock be used to circumvent the statutory scheme of §306?

3. *"Bail-outs" under §115(g) of the 1939 Code.* The problem of the preferred stock "bail-out" is not new. Note the parenthetical phrase in §115(g) of the 1939 Code, quoted supra page 657. The prototype of §115(g), enacted in 1921, was directed *exclusively* at the redemption of shares that had been issued as stock dividends. The parenthetical phrase, subjecting redemptions to the test of §115(g) whether the stock was issued as a dividend or not, was enacted in 1926; among other reasons for its enactment was a realization that a corporation wishing to distribute cash at capital gains rates might redeem some of its originally issued stock on a pro rata basis, either getting along thereafter with a smaller stated capital or replacing the redeemed stock with a stock dividend at a subsequent time. For some time after 1926, however, the courts, influenced by §115(g)'s original purpose, were reluctant to apply it to the redemption of shares that had not been issued as a stock dividend. In the course of time, however, the courts departed more and more frequently from this restrictive construction. Bittker and Redlich, Corporate Liquidations and the Income Tax, 5 Tax L. Rev. 437, 466-468 (1950).

For discussions of the pre-1954 law, which by virtue of §306(h) remains applicable to dispositions and redemptions of stock received before the new Code took effect, see DeWind, Preferred Stock Bail-Outs and the Income Tax, 62 Harv. L. Rev. 1126 (1949); Darrell, Recent Developments in Nontaxable Reorganizations and Stock Dividends, 61 id. 958 (1948); Kanter, The Present Tax Status of Stock Dividends, 31 Taxes 418 (1953). In Rosenberg's Estate v. Commissioner, 36 T.C. 716 (1961), involving a transaction similar to that in the *Chamberlin* case, the Tax Court adhered to its view that the shareholders realized ordinary income on disposing of their shares; an appeal was dismissed on stipulation of the parties.

4. *Reference.* Alexander and Landis, Bail-Outs and the Internal Revenue Code of 1954, 65 Yale L.J. 909 (1956).

2. *Recapitalizations*

Section 354(a)(1) of the 1954 Code, relating to the recognition of gain or loss on exchanges of stock or securities in corporate reorganizations, is identical with §112(b)(3) of the 1939 Code.

Section 354(a)(2) of the 1954 Code, imposing a limitation on the "general rule" of §354(a)(1), has no counterpart in the 1939 Code.

Section 368(a)(1)(E) of the 1954 Code, defining "reorganization" to include a "recapitalization," is identical with §112(g)(1)(E) of the 1939 Code.

While the tax status of stock dividends has varied from time to time, it has always been clear that a distribution of its own *debt* securities by a corporation with earnings and profits is a taxable dividend. But the status of debt securities

issued by a corporation in the course of a corporate *recapitalization* has been less clear.

Before the 1954 Code was enacted, §112(b)(3) of the 1939 Code provided, as does the "general rule" laid down in §354(a)(1) of the 1954 Code, that no gain or loss was to be recognized if stock or securities of a corporation that was a party to a "reorganization" were exchanged for other stock or securities of the same corporation. Section 112(g)(1)(E) of the 1939 Code, like §368(a)(1)(E) of the 1954 Code, defined "reorganization" to include a "recapitalization." Suppose, then, that a corporation "recapitalized" by calling in its outstanding common stock and issuing in exchange other common stock (with a different par value or some other alteration of rights) plus bonds, debentures, or notes? Was the transaction a tax-free exchange of the old stock for the new stock and bonds or other securities? A taxable sale or exchange of the old stock? A dividend of the bonds or other securities? The case that follows considers this problem.

The effect of the enactment in 1954 of §354(a)(2), limiting the general rule of §354(a) if securities are received but not given up in the exchange (or if the principal amount of the securities received exceeds that of those that are surrendered), is examined in the note that follows the *Bazley* case.

BAZLEY v. COMMISSIONER

331 U.S. 737 (1947)

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

The proper construction of provisions of the Internal Revenue Code relating to corporate reorganizations is involved in both these cases. Their importance to the Treasury as well as to corporate enterprise led us to grant certiorari, 329 U.S. 695. While there are differences in detail to which we shall refer, the two cases may be disposed of in one opinion.

In the *Bazley* case, No. 287, the Commissioner of Internal Revenue assessed an income tax deficiency against the taxpayer for the year 1939. Its validity depends on the legal significance of the recapitalization in that year of a family corporation in which the taxpayer and his wife owned all but one of the Company's one thousand shares. These had a par value of $100. Under the plan of reorganization the taxpayer, his wife, and the holder of the additional share were to turn in their old shares and receive in exchange for each old share five new shares of no par value, but of a stated value of $60, and new debenture bonds, having a total face value of $400,000, payable in ten years but callable at any time. Accordingly, the taxpayer received 3,900 shares of the new stock for the 798 shares of his old holding and debentures in the amount of $319,200. At the time of these transactions the earned surplus of the corporation was $855,783.82.

The Commissioner charged to the taxpayer as income the full value of the debentures. The Tax Court affirmed the Commissioner's determination, against the taxpayer's contention that as a "recapitalization" the transaction was a tax-free "reorganization" and that the debentures were "securities in a corporation a party to a reorganization," "exchanged solely for stock or securities in such corporation" "in pursuance of a plan of reorganization," and as such no gain is recognized for income tax purposes. [§§368(a)(1)(E) and 354(a)(1).*] The Tax Court found that the recapitalization had "no legitimate corporate business purpose" and was therefore not a "reorganization" within the statute. The distribution of debentures, it concluded, was a disguised dividend, taxable as earned income under [§§61(a) and 301]. 4 T.C. 897. The Circuit Court of Appeals for

* Section 354(a)(2), which limits the general rule of §354(a)(1), was not enacted until 1954. — ED.

the Third Circuit, sitting en banc, affirmed, two judges dissenting 155 F.2d 237.

Unless a transaction is a reorganization contemplated by [§368(a)], any exchange of "stock or securities" in connection with such transaction, cannot be "in pursuance of the plan of reorganization" under [§354]. While [§368(a)] informs us that "reorganization" means, among other things, "a recapitalization," it does not inform us what "recapitalization" means. "Recapitalization" in connection with the income tax has been part of the revenue laws since 1921. Congress has never defined it and the Treasury Regulations shed only limited light. Treas. Reg. [§1.368-1(b)]. One thing is certain. Congress did not incorporate some technical concept, whether that of accountants or of other specialists, into [§368(a)], assuming that there is agreement among specialists as to the meaning of recapitalization. And so, recapitalization as used in [§368(a)] must draw its meaning from its function in that section. It is one of the forms of reorganization which obtains the privileges afforded by [§368(a)]. Therefore, "recapitalization" must be construed with reference to the presuppositions and purpose of [§368(a)]. It was not the purpose of the reorganization provision to exempt from payment of a tax what as a practical matter is realized gain. Normally, a distribution by a corporation, whatever form it takes, is a definite and rather unambiguous event. It furnishes the proper occasion for the determination and taxation of gain. But there are circumstances where a formal distribution, directly or through exchange of securities, represents merely a new form of the previous participation in an enterprise involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets. As to these, Congress has said that they are not to be deemed significant occasions for determining taxable gain.

These considerations underlie [§368(a)] and they should dominate the scope to be given to the various sections, all of which converge toward a common purpose. Application of the language of such a revenue provision is not an exercise in framing abstract definitions. In a series of cases this Court has withheld the benefits of the reorganization provision in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind with which [§354], in its purpose and particulars, concerns itself. See Pinellas Ice & Cold Storage Co. v. Commissioner [infra p. 726]; Gregory v. Helvering [infra p. 707]; Le Tulle v. Scofield [infra p. 729].

Congress has not attempted a definition of what is recapitalization and we shall follow its example. The search for relevant meaning is often satisfied not by a futile attempt at abstract definition but by pricking a line through concrete applications. Meaning frequently is built up by assured recognition of what does not come within a concept the content of which is in controversy. Since a recapitalization within the scope of [§368(a)] is an aspect of reorganization, nothing can be a recapitalization for this purpose unless it partakes of those characteristics of a reorganization which underlie the purpose of Congress in postponing the tax liability.

No doubt there was a recapitalization of the Bazley corporation in the sense that the symbols that represented its capital were changed, so that the fiscal basis of its operations would appear very differently on its books. But the form of a transaction as reflected by correct corporate accounting opens questions as to the proper application of a taxing statute; it does not close them. Corporate accounting may represent that correspondence between change in the form of capital structure and essential identity in fact which is of the essence of a transaction relieved from taxation as a reorganization. What is controlling is that a new arrangement intrinsically partake of the elements of reorganization which underlie the Congressional exemption and not merely give the appearance of it to ac-

complish a distribution of earnings. In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization. The governing legal rule can hardly be stated more narrowly. To attempt to do so would only challenge astuteness in evading it. And so it is hard to escape the conclusion that whether in a particular case a paper recapitalization is no more than an admissible [inadmissible?] attempt to avoid the consequences of an outright distribution of earnings turns on details of corporate affairs, judgment on which must be left to the Tax Court. See Dobson v. Commissioner, 320 U.S. 489.

What have we here? No doubt, if the Bazley corporation had issued the debentures to Bazley and his wife without any recapitalization, it would have made a taxable distribution. Instead, these debentures were issued as part of a family arrangement, the only additional ingredient being an unrelated modification of the capital account. The debentures were found to be worth at least their principal amount, and they were virtually cash because they were callable at the will of the corporation which in this case was the will of the taxpayer. One does not have to pursue the motives behind actions, even in the more ascertainable forms of purpose, to find, as did the Tax Court, that the whole arrangement took this form instead of an outright distribution of cash or debentures, because the latter would undoubtedly have been taxable income whereas what was done could, with a show of reason, claim the shelter of the immunity of a recapitalization-reorganization.

The Commissioner, the Tax Court and the Circuit Court of Appeals agree that nothing was accomplished that would not have been accomplished by an outright debenture dividend. And since we find no misconception of law on the part of the Tax Court and the Circuit Court of Appeals, whatever may have been their choice of phrasing, their application of the law to the facts of this case must stand. A "reorganization" which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under [§368]. This disposes of the case as a matter of law, since the facts as found by the Tax Court bring them within it. And even if this transaction were deemed a reorganization, the facts would equally sustain the imposition of the tax on the debentures under [§356(a)(1) and §356(a)(2)]. Commissioner v. Estate of Bedford, 325 U.S. 283. . . .

Other claims raised have been considered but their rejection does not call for discussion.

Judgments affirmed.

MR. JUSTICE DOUGLAS and MR. JUSTICE BURTON dissent in both cases for the reasons stated in the joint dissent of Judges Maris and Goodrich in the court below. Bazley v. Commissioner, 3 Cir., 155 F.2d 237, 244.

NOTE

1. *A change of form or of substance?* The Court says that Congress has determined that gain and loss shall not be recognized "where a formal distribution, directly or through an exchange of securities, represents merely a new form of the previous participation in an enterprise, involving no change of substance in the rights and relations of the interested parties one to another or to the corporate assets." Why is this not an apt description of the *Bazley* case recapitalization? Is is not more applicable to this exchange than to an exchange in the course of a statutory merger of two previously independent corporations, a transaction that is clearly included in the term "reorganization" by §368(a)(1)(A)?

If the transaction in the *Bazley* case was not a "reorganization," why was it not a sale

or exchange of the old common stock for the new common stock and the debentures, to be governed by §1036, §1031(b), and §1031(c)?

2. *The 1954 change in §354.* If the transaction had occurred after the enactment of the 1954 Code, the taxpayers in *Bazley* would have had to face an additional hurdle: the provision of §354(a)(2), enacted in 1954, which limits the general rule of §354(a)(1). By virtue of §354(a)(2), in conjunction with §356(a), the debentures would have been "boot" even if the transaction had been held a "reorganization."

3. *The effect of the Bedford case.* The *Bedford* case, cited by the Court, involved these facts: Under a recapitalization, a shareholder exchanged 3000 shares of cumulative preferred stock (par value $100) for 3500 shares of cumulative preferred stock (par value $75), 1500 shares of common stock (par value $1), and $45,240 in cash. The shareholder's gain (the difference between the adjusted basis of the shares given up and the value of the stock plus the cash received) was $139,740. The corporation's "earnings and profits" were sufficient to cover the entire cash distribution. It was admitted by the government that the transaction was a reorganization exchange, and it was admitted by the taxpayer that the cash was "boot." The only issue was whether under what is now §356(a)(1) and §356(a)(2) the "boot" should be taxed as capital gain or as a dividend. The Court, admitting that the matter "is not wholly free from doubt," concluded that because the corporation had earnings and profits, the distribution of cash had "the effect of the distribution of a taxable dividend." Its conclusion should be compared with the way the courts construed the phrase "essentially equivalent to the distribution of a taxable dividend" under §115(g) of the 1939 Code, supra page 657.

Although the *Bedford* case has sometimes been thought to establish that a distribution is ipso facto a dividend to the extent of the corporation's earnings and profits, it has not always been applied so austerely. See Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl. 1958) (boot held not to be the equivalent of a dividend). For discussion of the *Bedford* case, see Moore, Taxation of Distributions Made in Connection with a Corporate Reorganization, 17 Tax L. Rev. 129 (1961); Wittenstein, Boot Distributions and Section 112(c)(2); A Reexamination, 8 id. 63 (1952); Darrell, The Scope of Commissioner v. Bedford Estate, 24 Taxes 266 (1946).

4. *The "dividend-within-gain" concept of §356.* In citing §356 and the *Bedford* case as an alternative route to the same result reached by the "no reorganization" route, the Court may have overlooked the fact that §356 requires "boot" to be treated as a dividend only if, and to the extent that, the taxpayer realized a gain on the exchange itself. The value of the securities received in *Bazley* may well have exceeded the taxpayer's basis for the stock he surrendered, but there was no finding to this effect by the Tax Court.

5. *Use of debt in corporation's capital structure.* It has been seen previously that on original organization corporations often issue bonds or debentures to the incorporators, instead of only stock, so that the corporation can lay a basis for the deduction of interest under §163. Morover, the bonds can be retired at capital gains rates under §1232, whereas the redemption of stock would open the Pandora's box of §302. In addition, an accumulation of surplus by the corporation to pay off the indebtedness, unlike an accumulation for the purpose of redeeming stock, may be permissible under §531, supra page 625. The *Bazley* case and §354(a)(2) mean that a corporation which does not issue debt securities for these purposes to its stockholders at the time of organization will not find it easy to rectify its error later on.

Does the *Bazley* case also threaten the corporation which issues bonds or other evidences of indebtedness at the time of organization? Note the statement that the debentures "were virtually cash." Does this mean that they might be regarded as "boot" rather than "securities" if issued in a §351 transaction?

SEIDE v. COMMISSIONER

18 T.C. 502 (1952)

RAUM, Judge: The New Jersey Publishing Company had three classes of stock outstanding in August 1942: 1,600 shares of voting common, 2,500 shares of non-

voting common, 3,200 shares of non-voting 8 per cent cumulative preferred having a par value of $100. The shares of stock were held as follows:

Owner	Voting Common	Non-Voting Common	Preferred
Daisy Seide		850	1,300
Harold Seide	200	300	300
Joan Fagan Trust		200	400
Lois Fagan Trust		200	400
Frederick A. Seide	600	100	
Arthur L. Fagan	800	100	
Elizabeth M. Fagan		500	
Arthur L. Fagan Jr., Trust . .		250	
Elisabeth Fagan			160
Marilyn Fagan			160
Robert A. Fagan			160
Peter S. Fagan			160
Constance A. Fagan			160
Total	1,600	2,500	3,200

Pursuant to a plan of readjustment of its corporate structure, the Company issued a total of $320,000 face amount 8 per cent 20-year debentures in August 1942, and exchanged the debentures for all its preferred stock, each holder receiving a $1,000 debenture for 10 shares of preferred stock. The Company canceled the stock thus received and adjusted the capital on its books accordingly. In determining the deficiencies originally, the Commissioner apparently took the position that the distribution of the debentures in redemption and cancellation of the preferred stock was essentially equivalent to the distribution of a taxable dividend, within the meaning of §115(g) of the [1939] Revenue Code. The Commissioner now makes that contention only as to the four petitioners who held common (either voting or non-voting), and argues that the other five* realized capital gain upon receipt of the debentures and that they have not proved their basis in the preferred stock which they surrendered. We hold that the exchange of debentures for preferred stock was not essentially the equivalent of a taxable dividend and that the exchange was tax free pursuant to [§354(a)].†

Section [354] provides for the nonrecognition of gain or loss "if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation. . . ." And [§368(a)(1)(E)] defines "reorganization" to include "a recapitalization." There was here in fact a readjustment of the Company's capital structure, and there was an exchange of preferred stock solely for debentures. The transaction literally falls within the foregoing statutory provisions (cf. Wolf Envelope Co., 17 T.C. 471), and unless there are considerations which render these provisions inapplicable they are dispositive of the present controversy.

The situation here is wholly unlike that presented in Bazley v. Commissioner, 331 U.S. 737, where the form of reorganization was employed in an effort to achieve the distribution of a disguised dividend, and where it was held that the reorganization provisions were not intended to govern in such circumstances. The net effect of the transaction in the *Bazley* case was a pro rata distribution of debentures among stockholders in such manner as to render them the substantial equivalent of a cash dividend. No such circumstances are present here. The

* Only nine of the shareholders were parties to this proceeding. — Ed.

† The limitation of §354(a)(2) was not enacted until 1954. — Ed.

exchange of debentures for the preferred did not even remotely resemble a pro rata distribution of debentures among the holders of the two classes of common stock, considered either separately or together.

Five holders of the preferred stock owned no common stock whatever. The holders of 87½ per cent of the voting common owned no preferred and thus received no debentures. Similarly, several holders of a substantial block of non-voting common owned no preferred and likewise received no debentures. And finally, those holders of common who also owned preferred received debentures in percentages entirely unrelated to their holdings of common. To be sure, it is not a sine qua non of a taxable dividend that the distribution be made pro rata among the stockholders. But the fact that an alleged distribution is highly disproportionate raises a serious question whether it is in truth a disguised dividend.

Moreover, the debentures here involved were not readily marketable by reason of the following considerations: They were unsecured and had a remote maturity date, without likelihood of acceleration except in the event of dissolution or insolvency; there was the risk that they might be subordinated to the payment of other obligations; the Company had obsolete plant and equipment, and its business was in an unhealthy state, having sustained net losses in four of five preceding years and having fared poorly in relation to its competitors. The petitioners have asked us to find that the debentures had no fair market value at all. This we have not done, but the factors outlined above do show that the debentures could not readily have been sold, notwithstanding the Company's relatively strong balance sheet, and this fact is an additional element to be considered in determining whether the transaction was in fact a distribution of earnings rather than the reorganization which it purported to be. Taking all the facts into account we conclude that there was not here a distribution essentially equivalent to a taxable dividend. The *Bazley* case is not controlling; indeed, it points in the other direction.

Nor are the reorganization provisions inapplicable by reason of the absence of a "business purpose." One of the reasons for the elimination of the preferred stock was to wipe out the accumulated "deficit" in unpaid dividends, and we have no reason to conclude on this record that such objective was not attained. This was a valid business or corporate purpose . . . and the reorganization provisions, which otherwise literally cover this controversy, cannot therefore be rendered inapplicable.

NOTE

1. *Effect of the 1954 Code.* How would the foregoing reorganization be treated under the 1954 Code? Note that the table in the Court's opinion might be recast in the following form:

Owner	Voting Common	Non-Voting Common	Preferred
Seide Family	800	1250	1600
Fagan Family	800	1250	1600

In determining whether a recapitalization exchange "has the effect of the distribution of a dividend," §356(a)(2), can the effect on persons related to or controlled by the taxpayer be taken into account? Note that the constructive ownership rules of §318(a) come into force only when they "are expressly made applicable."

2. *Business purpose.* Does the last paragraph of the opinion mean that a "business purpose" must be served by the recapitalization, else the gain (or loss) will be recognized? Is there a difference between a "shareholder" business purpose and a "corporate" business purpose? The lower courts in the *Bazley* case had written extensively on the subject of

business purpose; note that the Supreme Court approved their conclusions "whatever may have been their choice of phrasing." See Bittker, What Is "Business Purpose" in Reorganization?, 8 N.Y.U. Inst. on Fed. Taxation 134 (1950).

See also Berner v. United States, 282 F.2d 720 (Ct. Cl. 1960), which discusses the relevance of the judicial requirement of a "continuity of interest" (infra p. 726) to recapitalizations.

3. *References.* Tarleau, Recapitalizations, 11 N.Y.U. Inst. on Fed. Taxation 371 (1953); Friedman and Silbert, Recapitalizations — Exchanges of Stock, Securities and Property of the Same Corporation Under the Internal Revenue Code of 1954, 13 id. 533 (1955).

Section J. Spin-Offs, Split-Offs, and Split-Ups

Section 355 of the 1954 Code, relating to divisive reorganizations, is derived, with substantial modifications, from §112(b)(11) and §112(b)(3) of the 1939 Code.

Section 356 of the 1954 Code, relating to the receipt of "boot," is derived, with modifications, from §112(c) and §112(e) of the 1939 Code.

Section 368(a)(1)(D) of the 1954 Code, defining the term "reorganization," is similar to §112(g)(1)(D) of the 1939 Code.

Section 368(b) and §368(c) of the 1954 Code, defining the terms "party to a reorganization" and "control" respectively, are similar to §112(g)(2) and §112(h) of the 1939 Code.

When the shareholders of a corporation no longer wish to entrust their eggs to one basket, there are various ways of getting them into several baskets. One is a corporate distribution to the stockholders of some of the assets; this will constitute a "dividend" if the corporation has earnings and profits. If instead, the assets are distributed to the shareholders in exchange for some of the corporation's stock, the distribution may run afoul of §302(d), supra page 652, at least if the distribution is on a pro rata basis.

Other methods of dividing up the corporate investment are the "spin-off," the "split-off," and the "split-up." In a *spin-off,* the existing corporation, A, transfers some of its assets to B Corporation, newly organized for the purpose, in exchange for B's stock, which A then distributes to its shareholders. In a *split-off,* A also transfers some of its assets to B for B's stock, but A distributes the B stock in exchange for part of its own stock. In a *split-up,* A transfers part of its assets to B Corporation and the rest to C Corporation, both newly organized for the purpose, and then completely liquidates, distributing the B and C stock in exchange for its own. The economic consequences to A's stockholders of all three methods are practically identical. Until 1954, however, the tax consequences of these transactions were quite divergent.

The split-up, under the 1939 Code, was a tax-free reorganization. The transfer of A's assets to B and C was a reorganization, as that term was defined by §112(g)(1)(D) (see §368(a)(1)(D) of the 1954 Code), and all three corporations were "parties to the reorganization" by virtue of §112(g)(2) (see §368(b) of the 1954 Code). Consequently A recognized neither gain nor loss on its exchanges of property for the stock or securities of B and C because of §112(b)(4) (see §361(a) of the 1954 Code). And A's stockholders recognized neither gain nor loss on their exchange of A stock for the stock or securities of B and C under §112(b)(3) (see §354(a) of the 1954 Code).

The spin-off, on the other hand, did not fit into the statutory sections just outlined. The transfer by A of a part of its assets to B constituted a "reorganization" under §112(g)(1)(D), so the corporation would recognize no gain or loss under §112(b)(4). But the distribution of the B stock to A's stockholders created

difficulty. This was because in a spin-off there is no *exchange* of stock by A's stockholders, as was required by §112(b)(3). Before 1934, as Gregory v. Helvering, infra page 707, indicates, no exchange was required, but the Revenue Act of 1934 amended the statute so as to require an exchange. Thus the spin-off became a taxable distribution (if the corporation had earnings and profits), and it retained this unhappy status until 1951. Section 112(b)(11) of the 1939 Code, added in 1951, allowed spin-offs to be accomplished tax-free, but only under certain restrictions. These restrictions were that both corporations must be intended to "continue the active conduct of a trade or business" after the spin-off and that the new corporation must not be "used principally as a device for the distribution of earnings and profits." These requirements, in modified form, have been carried over by the 1954 Code, but they are now applicable to all divisive reorganizations.

During the period (1934-1951) when the spin-off was a taxable dividend rather than a tax-free reorganization, the status of the split-off was rather uncertain. It could be fitted into the language of the 1939 Code, just as neatly as the split-up. But the Treasury's view was that the split-off was functionally equivalent to the spin-off (why?), and that the two should be treated identically for tax purposes. This contention was rejected by the Tax Court in Spangler v. Commissioner, 18 T.C. 976 (1952), and the Treasury finally conceded the point, Rev. Rul. 289, 1953-2 C.B. 37; but for many years the split-off was in general avoided by tax practitioners.

The foregoing discussion indicates that until 1954, the split-up was the safest method of dividing up a corporate enterprise. But it entailed a destruction of the old corporate entity, which might cause a loss of credits, carryovers, and other tax advantages, as well as the possible loss of franchises or favorable contracts, the confusion of customers, etc.

The 1954 Code seeks to treat all divisive reorganizations in the same way. Section 355 is the capstone of its structure; it is applicable both to distributions (spin-offs) and to exchanges (split-ups and split-offs). Moreover, the old corporation can distribute (a term that includes exchanges) the stock or securities of a controlled corporation that it already owns, whereas under the 1939 Code there could be no tax-free transfer except in a "reorganization," which required that the controlled corporation be created as part of the plan. The requirements of §355 that are of particular interest are §355(a)(1)(B) and §355(b). What types of transactions are they intended to forestall, and why? Note that these requirements are not explicitly imposed upon other types of reorganizations by §354. Section 354(b) is intended to prevent divisive reorganizations from taking place under §354 to avoid the more restrictive provisions of §355.

Note also that §355(a)(2) explicitly permits non-pro-rata distributions. This is important because the split-off and split-up can be used as a method of settling shareholder disputes by giving one group of assets to some of the shareholders and the rest to the others. For the pre-1954 difficulties in this area, see Williamson v. Commissioner, 27 T.C. 647 (1957); Lyons, Realignment of Stockholders' Interests in Reorganizations Under Section 112(g)(1)(D), 9 Tax L. Rev. 237 (1954).

We have been concerned in the foregoing discussion with the question of what types of transactions come within the letter of the statute. But this is an area in which literal compliance with the law has been only the first step; and many transactions have failed of their purpose because they did not have the right spirit. The cases that follow should be read not as ancient history, but for the light they shed on the practical problems with which §355 is concerned and on the approach that the courts are likely to adopt in construing it. Does the statute now carry its own safeguards so that the courts will say that Congress could not have intended them to act as policemen any longer?

GREGORY v. HELVERING

293 U.S. 465 (1935)

MR. JUSTICE SUTHERLAND delivered the opinion of the Court.

Petitioner in 1928 was the owner of all the stock of United Mortgage Corporation. That corporation held among its assets 1,000 shares of the Monitor Securities Corporation. For the sole purpose of procuring a transfer of these shares to herself in order to sell them for her individual profit, and, at the same time, diminish the amount of income tax which would result from a direct transfer by way of dividend, she sought to bring about a "reorganization" under §112(g) of the Revenue Act of 1928, set forth later in this opinion. To that end, she caused the Averill Corporation to be organized under the laws of Delaware on September 18, 1928. Three days later, the United Mortgage Corporation transferred to the Averill Corporation the 1,000 shares of Monitor stock, for which all the shares of the Averill Corporation were issued to the petitioner. On September 24, the Averill Corporation was dissolved, and liquidated by distributing all its assets, namely, the Monitor shares, to the petitioner. No other business was ever transacted, or intended to be transacted, by that company. Petitioner immediately sold the Monitor shares for $133,333.33. She returned for taxation, as capital net gain, the sum of $76,007.88, based upon an apportioned cost of $57,325.45. Further details are unnecessary. It is not disputed that if the interposition of the so-called reorganization was ineffective, petitioner became liable for a much larger tax as a result of the transaction.

The Commissioner of Internal Revenue, being of opinion that the reorganization attempted was without substance and must be disregarded, held that petitioner was liable for a tax as though the United Corporation had paid her a dividend consisting of the amount realized from the sale of the Monitor shares. In a proceeding before the Board of Tax Appeals, that body rejected the commissioner's view and upheld that of petitioner. 27 B.T.A. 223. Upon a review of the later decision, the Circuit Court of Appeals sustained the commissioner and reversed the board, holding that there had been no "reorganization" within the meaning of the statute. 69 F.(2d) 809. Petitioner applied to this court for a writ of certiorari, which the government, considering the question one of importance, did not oppose. We granted the writ. 293 U.S. 538.

Section 112 of the Revenue Act of 1928 deals with the subject of gain or loss resulting from the sale or exchange of property. Such gain or loss is to be recognized in computing the tax, except as provided in that section. The provisions of the section, so far as they are pertinent to the question here presented, follow:

> Sec. 112. . . . (g) *Distribution of Stock in Reorganization.* If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized. . . .
>
> (i) *Definition of Reorganization.* As used in this section . . .
>
> (1) The term "reorganization" means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred. . . .

It is earnestly contended on behalf of the taxpayer that since every element required by the foregoing subdivision (B) is to be found in what was done, a statutory reorganization was effected; and that the motive of the taxpayer thereby

to escape payment of a tax will not alter the result or make unlawful what the statute allows. It is quite true that if a reorganization in reality was effected within the meaning of subdivision (B), the ulterior purpose mentioned will be disregarded. The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. United States v. Isham, 17 Wall. 496, 506; Superior Oil Co. v. Mississippi, 280 U.S. 390, 395, 396; Jones v. Helvering, 71 F.(2d) 214, 217. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended. The reasoning of the court below in justification of a negative answer leaves little to be said.

When subdivision (B) speaks of a transfer of assets by one corporation to another, it means a transfer made "in pursuance of a plan of reorganization" (section 112(g)) of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here. Putting aside, then, the question of motive in respect of taxation altogether, and fixing the character of the proceeding by what actually occurred, what do we find? Simply an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to transfer a parcel of corporate shares to the petitioner. No doubt, a new and valid corporation was created. But that corporation was nothing more than a contrivance to the end last described. It was brought into existence for no other purpose; it performed, as it was intended from the beginning it should perform, no other function. When that limited function had been exercised, it immediately was put to death.

In these circumstances, the facts speak for themselves and are susceptible of but one interpretation. The whole undertaking, though conducted according to the terms of subdivision (B), was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose.

Judgment affirmed.

NOTE

1. *The scope of Gregory.* This is one of the most famous cases in our field, and it has been almost all things to all men. Judge L. Hand, who had decided the case in the Court of Appeals, once wrote of the case:

> In Gregory v. Helvering . . . , the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world. [Chisolm v. Commissioner, 79 F.2d 14, 15 (2d Cir. 1935).]

Is this explanation consistent with the following later comment by Judge Hand?

> The doctrine of Gregory v. Helvering . . . means that in construing words of a tax statute which describes commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and

not to include transactions entered upon for no other motive but to escape taxation. [Commissioner v. Transport Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949).]

2. *The statutory changes of 1934, 1951, and 1954.* The statutory provision making a spin-off tax-free was repealed by the Revenue Act of 1934, before the *Gregory* case was decided by the Supreme Court. This action by Congress was partly the result of the fact that the Board of Tax Appeals in 1932 had decided the *Gregory* case in the taxpayer's favor, saying: "A statute so meticulously drafted must be interpreted as a literal expression of the taxing policy, and leaves only the small interstices for judicial consideration." 27 B.T.A. 223, 225. Thereafter, until §112(b)(11) of the 1939 Code was enacted by the Revenue Act of 1951, a spin-off was a taxable distribution. In 1954, §355 was enacted to put all divisive reorganizations on a par, regardless of the form used.

BONSALL v. COMMISSIONER
317 F.2d 234 (2d Cir. 1963)

Before SMITH, KAUFMAN and MARSHALL, Circuit Judges.

J. JOSEPH SMITH, Circuit Judge.

Albany Linoleum & Carpet Company was organized in 1924 and since that time has engaged in the wholesale distribution of various floor covering materials. Its largest supplier has been Armstrong Cork Company. Henry and Martha Bonsall, husband and wife, have at all pertinent dates been the controlling shareholders and principal officers of Albany Linoleum. C. Jordan Vail and his wife Nancy were minority shareholders, and he was an employee of the company. Albany Linoleum acquired its principal place of business at 64 Northern Boulevard in Albany, New York, in 1945, at a cost of roughly $75,000. The gross usable floor area of this building was 40,200 square feet. At the same time, it acquired a small adjoining building located at 231 Elk Street. The gross usable floor area of these premises was 3,312 square feet. From 1946 to 1956 Albany Linoleum leased 2,770 square feet of its Northern Boulevard building to Armstrong Cork Company. From 1949 to 1954 the Elk Street building was leased to Albany Poultry Company. Rental income in comparison to corporate income as a whole can be summarized as follows:

Year	Gross profit from sales	Gross rental income	Net income
1952	$318,650.55	$1,710.00	$40,955.17
1953	333,118.52	1,350.00	43,309.75
1954	322,412.45	1,158.00	32,865.77
1955	351,479.74	1,054.00	36,853.84
1956	388,890.81	628.00	38,951.81

In 1956 it was decided to tear down the Elk Street building and put up an addition to the Northern Boulevard property. To raise construction funds and pay off the current mortgage, a new mortgage was financed through the Albany Savings Bank for $90,000. The bank required that a new corporation be formed to take title to the property with Albany Linoleum as tenant, as a condition to making the loan, and that the lease rentals be assigned by that new corporation to the bank as collateral for the loan. In compliance with this requirement, the shareholders of Albany Linoleum voted to form Abon, Inc. to acquire its buildings on Northern Boulevard and Elk Street. The certificate of incorporation was filed with the Secretary of State of New York on July 27, 1956, providing for 1,500 shares of stock at $100 par value.* On August 2, 1956 a meeting was held at

* By subsequent amendment, the authorized shares were increased to 150,000, with a par value of $1.00 each — ED.

which Bonsall and his wife and three others were elected directors, and Vail, Bonsall's son, and one Jones were elected as officers. It was then resolved to accept an offer from Albany Linoleum to convey the properties to Abon in return for assumption of an existing mortgage of $54,000, obligations pursuant to the building of the addition, and issuance of its stock to the Albany Linoleum shareholders, one share for every twenty shares of Albany Linoleum stock owned. Bonsall and his wife each owned 9,300 shares of Albany Linoleum stock, entitling them to 466 shares each of Abon stock; Vail and his wife owned a total of 700 shares of Albany Linoleum stock, entitling them to 35 shares of Abon stock.

A meeting of Abon stockholders was held on September 12, 1956 at which the prior acts of the incorporators and directors were ratified. Vail, Bonsall, and Bonsall's wife signed the minute book of this meeting. Mr. and Mrs. Bonsall also executed a written waiver of notice. The next day, title to the properties at 64 Northern Boulevard and 231 Elk Street was conveyed to Abon and accepted by its directors, and a lease of the premises was executed between Abon and Albany Linoleum. Abon then drew a mortgage loan of $90,000 from Albany Savings Bank, and assigned its future rentals due as collateral, pursuant to the prior agreement. The fair market value of net assets transferred to Abon was $9,707.87 or $7.96 per share, computed on the basis of 1219 shares required to be issued under the agreement with Albany Linoleum. . . .

Abon filed a corporate income tax return for 1956 reporting an entry for common stock of $1,219 on March 15, 1957. Albany Linoleum's balance sheet as of December 31, 1956 showed no stock or other ownership in Abon but did reflect decreases in land and buildings and other fixed depreciable assets. Bonsall and his wife and Vail and his wife did not report any Abon stock received from Albany Linoleum as a dividend for 1956 on their returns for that year. The Commissioner of Internal Revenue asserted that Bonsall and his wife received an added $7,418.72 in dividend income — the value of the Abon stock — and determined an income tax deficiency of $4,027.91. Vail and his wife were likewise found to have failed to report $278.60 in dividend income with a resulting deficiency of $50.25. Petitioners argued in the Tax Court that no distribution of Abon stock was made to them until 1957, and even if made in 1956, that it was tax-free within the Internal Revenue Code of 1954, §355. The Tax Court rejected these contentions and sustained the deficiencies. Taxpayers petition to review that decision. We affirm.

[The court affirmed the decision below that the distribution was made in 1956 rather than in 1957.]

The petitioners assert that even if the stock was transferred to them in 1956 it is not taxable as a dividend because of the effect of Internal Revenue Code of 1954, §355. (It should be noted that they concede that the distribution was made to them by Albany Linoleum even though it never actually owned the stock.) That section provides, as relevant here, that if a corporation distributes to a shareholder with respect to his stock, stock of a corporation which it controls immediately prior to the distribution and (1) the transaction was not used primarily as a device for distributing the earnings and profits of either corporation, (2) the requirements of [§355(b)] relating to the active conduct of businesses are satisfied, and (3) at least a controlling percentage (as defined) of the stock of the subsidiary is distributed, then no gain or loss shall be recognized to the shareholder on receipt of the stock. The requirements of [§355(b)] are, in part, that the distributing corporation and the subsidiary corporation both be engaged in the "active conduct of a trade or business" immediately after the distribution. A corporation can be so regarded only if "such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution."

Other limitations are set down that are not applicable here. The Tax Court found that Albany Linoleum had not been engaged in the active conduct of a real-estate rental business for five years prior to the distribution and therefore that Abon was not engaged in the active conduct of a trade or business within the meaning of the statute.

There is ample support for the factual determination that Albany Linoleum was not actively conducting a real-estate rental business. As the table above indicates, the portion of its income realized from real estate rentals was minute. There was testimony by Bonsall himself tending to negate active efforts at promoting rentals: the buildings had never been listed with an agent, nor were there even signs on them indicating that space was available. No activity appeared beyond a few casual conversations with prospective tenants. Moreover, most of the floor-space of the two buildings combined was occupied by the floor-covering business. Only a very small part was available for rental, and an even smaller part actually leased. The continuing rental to Armstrong Cork Co. which provided most of the rental income appeared to be an accommodation to a large supplier of the floor-covering business and thus an adjunct to it, rather than indicative of an independent business, for the Tax Court found that the premises were let at less than fair rental value over the five-year period. Finally, no separate records of rental income and expenses were kept. Absence of such records is at least probative of the fact that the managers of Albany Linoleum did not regard it as engaged in an independent rental business. The Tax Court was plainly justified in concluding that the small amount of rental activity was merely an incidental part of the sole business of the corporation — wholesale floor-coverings. See Theodore F. Appleby, 35 T.C. 755 (1961), aff'd per curiam, Appleby v. C.I.R., 296 F.2d 925 (3 Cir.), cert. denied, 370 U.S. 910; Isabel A. Elliott, 32 T.C. 283 (1959).

Petitioners argue in reply that even if Albany Linoleum is found to have been conducting but one business, the recent decision of the Tax Court in Edmund P. Coady, 33 T.C. 771 (1960), aff'd per curiam, C.I.R. v. Coady, 289 F.2d 490 (6 Cir., 1961), permits the tax-free division of that business as has been done in this case. This is to misconceive the scope of that decision. *Coady* only decided that the division of a single business into two operating halves, each continuing the previous activity (which had been carried on for more than five years) could fall within §355, invalidating the Regulation that stated that the section did not apply to division of a single business as unauthorized by the statute. See Regs. §1.355-1(a). Each corporation was engaged in the "active conduct of a trade or business" within the statute because it could be traced back through five years or more of the same activity, whether it was an old or new corporate entity. That is not true here. As the Tax Court properly found no prior real estate rental business, Abon must be taken to have embarked on a wholly new venture when it was formed. It is lacking the five-year history that the statute requires for "active conduct of a trade or business."

It is clear that careful scrutiny of purported "real-estate rental" businesses is necessary to prevent evasion of the purposes of the statute. The possibility of the shareholders abstracting accumulated earnings at capital gains rates is present whenever a corporation owns its own factory or office building. Under taxpayers' interpretation, all that need be done is to transfer the building to a new corporation and distribute the stock received in return. The shareholders would then be free to sell their stock and pay a capital gains rate on the proceeds while the corporation can rent or purchase another building and reduce its accumulated earnings. The present case is little more than that, and it is noteworthy that the two prior cases decided under this section other than *Coady,* Theodore F. Ap-

pleby, supra, and Isabel A. Elliott, supra, were likewise factually similar. Only long application may completely clarify the difficult terminology of section 355. But obvious cases such as presented here plainly must be excluded from tax-free treatment.

The Commissioner also urged before the Tax Court that the transaction was disqualified from tax-free treatment by the express provision of section 355(a)(1)(B) as it was "used principally as a device for the distribution of the earnings and profits of the distributing corporation." As the Tax Court found it unnecessary to pass on this point, the Commissioner argued in this Court that a remand for further findings should be made if his contention that there was no active rental business were not sustained. In view of our disposition of the case, we need not pass on this question. It should be noted, however, that there was no valid shareholder business purpose for the distribution of the Abon shares. The reasons for the creation of Abon were adequate, but no necessity for the distribution of its stock was shown. See Parshelsky's Estate v. Commissioner, 303 F.2d 14 (2 Cir., 1962).

The distribution of Abon stock to Albany Linoleum shareholders was taxable as a dividend in 1956. It being undisputed that Albany Linoleum had earnings and profits on December 31, 1956 far in excess of the fair market value of the stock, the dividend is properly taxable at ordinary income rates. See Internal Revenue Code of 1954, §§301, 316.

The decision of the Tax Court is affirmed.

REV. RUL. 59-400

1959-2 C.B. 114

Advice has been requested whether a distribution of stock by a corporation engaged in the hotel and real estate business qualifies under the nontaxable provisions of section 355 of the Internal Revenue Code of 1954.

M corporation was engaged in two businesses, operating a hotel and renting improved real estate (both commercial and residential). The hotel business was started upon organization in 1920 and has been actively conducted up to the present time. In 1934, *M* corporation also entered into the rental real estate business when it purchased property, constructed a garage and automobile agency facilities thereon and rented it to a dealer. In the intervening years, it acquired other rental properties which it has continued to operate. In 1954, the hotel had a fair market value of 550*x* dollars and a net book value of 350*x* dollars. The rental properties had a fair market value of 305*x* dollars and a net book value of 167*x* dollars.

During the five-year period commencing with 1954, the operation of the hotel business resulted in earnings, after taxes, of 240*x* dollars, and the operation of the real estate business resulted in earnings of approximately 75*x* dollars. In 1958, a new rental office building was built for 400*x* dollars, some 175*x* dollars thereof being provided by loans from banks. At the beginning of 1959, the hotel business was placed in a new corporation *N*, and the stock thereof distributed to the shareholders of *M* on a pro rata basis. *N* corporation received the hotel, plus certain receivables and other hotel business assets. *M* corporation retained the real estate liabilities and assets, which at that time had a net book value of 372*x* dollars and a fair market value of 705*x* dollars.

Section 355 of the Code states, in part, that in order for a distribution of stock to qualify under the nontaxable provisions of such section, each of the corporations involved must be engaged in a trade or business which has been actively conducted throughout the five-year period ending on the date of distribution,

and that the transaction must not be used principally as a device to distribute the earnings and profits of either corporation.

The purpose behind the five-year limitation of section 355 is to prevent the corporate earnings of one business from being drawn off for such a period and put into a new business and thereby, through the creation of a marketable enterprise, convert what would normally have been dividends into capital assets that are readily saleable by the shareholders.

It is the position of the Internal Revenue Service that where a corporation which is devoted to one type of business also engages in the rental business, and substantial acquisitions of new rental property are made within the five-year period preceding the separation of these businesses, a "spin-off" transaction will not qualify under section 355 unless it can be shown that the property acquisitions were substantially financed out of the earnings of the rental business and not out of the earnings of the other business.

From the facts presented herein, it is readily apparent that there has been a very substantial increase in the rental properties subsequent to 1954, primarily as a result of the addition of the large office building in 1958. Further, it is also apparent that, viewing the transaction most favorably to the taxpayer, earnings properly attributable to the hotel business, in the amount of approximately 150*x* dollars, have been employed in increasing the real estate business. In view of this substantial financing out of the earnings of the hotel business, it is held that the distribution of the stock of *N* corporation to the shareholders of *M* corporation will not qualify as a nontaxable distribution under section 355 of the Code.

NOTE

1. *Requirement of "active conduct of a trade or business."* When the tax-free spin-off was reinstated in 1951 by §112(b)(11) of the 1939 Code, its advantages were denied if "it appears that . . . any corporation which is a party to such reorganization was not intended to continue the active conduct of a trade or business after such reorganization." This provision, which presumably stemmed from a fear of Gregory-type spin-offs, would have permitted a single business to be split into two businesses by the spin-off itself, so long as both were to be actively conducted thereafter. Did §355(b) intend to call a halt to this possibility of dividing an existing business into two separate enterprises? If so, why? Note how the Treasury interpreted the requirement of §355(b)(1)(A) in Examples (2), (5), (11), (12), and (16) of Regs. §1.355-1(d). Do these transactions resemble dividends?

In the *Coady* case, cited by the court in *Bonsall*, a corporation engaged in the heavy construction business, for the purpose of settling a dispute between its two shareholders, transferred a contract for the construction of a sewage disposal plant at Columbus, Ohio, part of its equipment and cash, and some other items to a newly created corporation, and distributed all of the new corporation's stock in exchange for all of its own stock owned by one of the shareholders. The distributing corporation, which thus became wholly owned by the other shareholder, was left with a contract for the construction of another sewage plant in Charleston, West Virginia, and the balance of the equipment and cash. Relying on the fact that before the split-off there was only a single business, rather than two five-year old businesses, the Internal Revenue Service held that the transaction did not satisfy the requirements of §355(b). The Tax Court (affirmed per curiam by the Court of Appeals for the Sixth Circuit) rejected the government's contention and held that the two-business requirement of Regs. §1.355-1(a) was invalid:

> Respondent [Commissioner] maintains that a reading of §355(b)(2)(B) in conjunction with the requirement of §355(b)(1) that both "the distributing corporation, *and* the controlled corporation . . . , [be] engaged immediately after the distribution in the active conduct of a trade or business" (emphasis supplied) indicates Congress intended the provisions of the statute to apply only where, immediately after the

distribution, there exist two separate and distinct businesses, one operated by the distributing corporation and one operated by the controlled corporation, both of which were actively conducted for the 5-year period immediately preceding the distribution. In our judgment the statute does not support this construction.

As noted, the only reference to plurality appears in section 355(b)(1), and deals with corporate entities, not businesses. Recognizing the divisive nature of the transaction, subsection (b)(1) contemplates that where there was only one corporate entity prior to the various transfers, immediately subsequent thereto, there will be two or more *corporations*. In order to insure that a tax-free separation will involve the separation only of those assets attributable to the carrying on of an active trade or business, and further to prevent the tax-free division of an active corporation into active and inactive entities, (b)(1) further provides that each of the surviving corporations must be engaged in the active conduct of *a* trade or business.

A careful reading of the definition of the active conduct of a trade or business contained in subsection (b)(2) indicates that its function is also to prevent the tax-free separation of *active* and *inactive* assets into *active* and *inactive* corporate entities. This is apparent from the use of the adjective "such," meaning before-mentioned, to modify "trade or business" in subsection (b)(2)(B), thus providing that the trade or business, required by (b)(2)(B) to have had a 5-year active history prior to the distribution, is the same trade or business which (b)(2)(A) requires to be actively conducted immediately after the distribution. Nowhere in (b)(2) do we find, as respondent suggests we should, language denying the benefits of section 355 to the division of a single trade or business.

Nor can respondent derive support for his position by reading subsections (b)(1) and (b)(2) together, inasmuch as the plurality resulting therefrom is occasioned, not by any requirement that there be a multiplicity of businesses, but rather by the divisive nature of the transaction itself: i.e., one corporation becoming two or more corporations. Moreover, from the fact that the statute requires, immediately after the distribution, that the surviving corporations each be engaged in the conduct of a trade or business with an active 5-year history, we do not think it inevitably follows that each such trade or business necessarily must have been conducted on an individual basis throughout that 5-year period. As long as the trade or business which has been divided has been actively conducted for 5 years preceding the distribution, and the resulting businesses (each of which in this case, happens to be half of the original whole) are actively conducted after the division, we are of the opinion that the active business requirements of the statute have been complied with. [33 T.C. 771, 777, 778 (1960).]

Six judges of the Tax Court dissented, one without opinion and five on the ground that the statute was susceptible to different interpretations and that the Treasury Regulations were not unreasonable or inconsistent with its purpose.

The Tax Court's decision in *Coady* was affirmed, 289 F.2d 490 (6th Cir. 1961), and the Court of Appeals for the Fifth Circuit came to the same conclusion in United States v. Marett, 325 F.2d 28 (5th Cir. 1963). Thereafter, the Internal Revenue Service announced that it would follow these decisions, and that modifications of the regulations and of Rev. Rul. 61-198, 1961-2 C.B. 61 (non-acquiescence in *Coady*) were under consideration. TIR-564 (April 3, 1964).

Note that §346(b) requires that the corporation, at the time of a partial liquidation, be engaged in the conduct of two businesses; see S. Rept. on 1954 Code, p. 262: "the distributing corporation must be engaged in the active conduct of at least 2 businesses which must have been actively conducted (whether or not by it) for the 5-year period." Does this interpretation of §346(b) shed any light on the problem before the court in the *Coady* case?

If the real estate in the *Bonsall* case had been put into a subsidiary corporation and rented to the parent corporation for five years, would the subsidiary be actively engaged in a five-year-old business so that a distribution of its stock would meet the requirements of §355? Recall that rental real estate is ordinarily "used in the trade or business" for purposes of §1221(2) and §1231, supra page 549; does this mean that the owner of such

property is "engaged in the active conduct of a trade or business" within the meaning of §355(b)?

2. *A "device" for the distribution of earnings and profits?* The "device" language of §355(a)(1)(B) comes from §112(b)(11) of the 1939 Code. Why is a pre-arranged sale of the stock of either the distributing or the controlled corporation viewed with such suspicion by §355(a)(1)(B) and Regs. §1.355-2(b)? See also Rev. Rul. 55-103, 1955-1 C.B. 31.

In *Parshelsky's Estate* (cited in *Bonsall* in connection with the "device" provision of §355) the court said of the "device" language of §112(b)(11) of the 1939 Code:

> Normally when a corporation distributes assets to its shareholders or sells the assets and distributes their proceeds, a dividend results and the shareholders pay ordinary income tax. However, if the corporation is permitted to transfer the assets to a new corporation and distribute the new corporation's stock to its shareholders in a tax-free spin-off, the shareholders could completely liquidate the new corporation or sell its stock, thus realizing capital gain rather than ordinary income. Because of these tax-avoidance possibilities, Congress intended to limit tax exemption to those spin-offs where the taxpayer had corporate or shareholder purposes such as would motivate a reasonable businessman to effect a spin-off. Therefore, the court must first ascertain the taxpayer's corporate and shareholder purposes and then evaluate their validity on such an objective basis.
>
> Parshelsky's executors argue that one reason for the spin-off was to remove the valuable real estate from the hazards of the declining wholesale business. However, after the reorganization Parshelsky Brothers retained in excess of $750,000 in Treasury notes and cash, and the corporation's current liabilities had declined to approximately $16,000. In short, these facts lend little support to this argument of the executors. Moreover, the real estate could have been safguarded from the creditors of the wholesale business merely by having Parshelsky Brothers transfer the wholesale business to a subsidiary corporation and retain the real estate. In light of the tax-avoidance possibilities which a spin-off often provides, there must be non-tax reasons not only for the separation of the two businesses but also for direct ownership of both by the shareholders. The fact that creation of a subsidiary corporation would necessarily bring with it either the intercorporate dividend tax or the additional tax on corporations filing a consolidated return is not by itself sufficient to justify split ownership at the shareholder level. [303 F.2d 14, 20 (2d Cir. 1962).]

The court in *Parshelsky's Estate* also held that the business purpose for "split ownership at the shareholder level" could be a "shareholder," instead of a "corporate," business purpose (other than tax-avoidance):

> We find, therefore, that the Tax Court erred in this case when it examined only those reasons for the reorganization "relating to the business being carried on by the corporation, or relating otherwise to the corporation's organization or functioning" and refused to examine those "arising from and serving only the personal or noncorporate-business interests of the shareholders." [303 F.2d at p. 19.]

In harmony with this conclusion, the court held that the consummation of a plan under which the two corporations were to be transferred by will to different legatees was a business purpose for the spin-off, and this was evidently regarded as rebutting — or at least helping to rebut — the government's charge that the transaction was a "device" to distribute earnings and profits.

The Regulations state that a transaction does not qualify under §355 if "carried out for purposes not germane to the business of the corporation." Regs. §1.355-2(c). Does this mean that §355 is more restrictive than §122(b)(11) of the 1939 Code, as construed by *Parshelsky's Estate?*

3. *Distributions of securities or preferred stock.* Under §112(b)(11) of the 1939 Code, only common stock could be spun-off. This restriction was intended to prevent a tax-free spin-off of preferred stock as the first step in a bail-out of earnings and profits. Section 355 of the 1954 Code imposes no restriction on the type of stock or securities to be distributed in a divisive reorganization. If securities are distributed, however, they will

constitute "boot" under §356(d) to the extent that their principal amount exceeds the principal amount of any securities that are surrendered; and if preferred stock is distributed, it may be "tainted" by virtue of §306(c)(1)(B).

4. *Distribution of all, or substantially all, of controlled corporation's stock and securities.* By virtue of §355(a)(1)(D), the distributing corporation must either distribute all of the stock and securities which it holds in the controlled corporation or distribute an amount of stock constituting "control" (as defined by §368(c)) and satisfy the Treasury that the retention of stock in the controlled corporation was not in pursuance of a tax avoidance plan. For a somewhat similar provision, see Regs. 118, §39.112(b)(11)-2(c), issued under §112(b)(11) of the 1939 Code. Why this emphasis on a complete, or virtually complete, separation of the two corporations?

5. *Criss-cross transactions.* If A owns 50 per cent of the stock of X Corporation and of Y Corporation and B owns the other 50 per cent of X and Y, can they employ §355 to effect a division of their investments so that A will become the sole owner of X and B the sole owner of Y? What might be the mechanics of such a division? Compare Badanes v. Commissioner, 39 T.C. 38 (1962), with Regs. §1.355-3(a) (last sentence). Does the *Badanes* case sanction the use of §355 to accomplish an exchange under which A, owning all of the stock of X Corporation and B, owning all of the stock of Y Corporation, each succeed in becoming the sole owner of the other man's corporation?

6. *Non-qualifying transactions.* The transactions in *Bonsall* and in Rev. Rul. 59-400 were spin-offs. If a spin-off does not qualify under §355, the distribution falls under §301 and will be taxed as a dividend to the extent of the distributing corporation's earnings and profits. If the transactions had been split-offs, in which the shareholders had surrendered an appropriate portion of the old corporation's stock in exchange for the stock of the controlled corporation, what would be the effect of failing to qualify under §355? Could the transaction be taxed as a sale of the old stock? Would §302 or §346 be applicable? Or would the transaction be a dividend distribution?

7. *Jury trials under §355.* Occasionally a case involving an issue like the validity of a spin-off is submitted to a jury in a District Court refund case. A recent example is Rinkel v. Knox, reported at 7 A.F.T.R.2d 943 (1961), where the judge's charge to a jury included the following:

> Members of the jury, I suppose when you reported for work this morning you didn't expect to get such a concentrated course in economics, but you have paid very good attention to a subject matter that is strange to most of us. Really, it's a relatively easy question that's going to be submitted to you, although it's not easy to explain what that question is.
>
> Most of these income tax cases are tried to the Court without a jury so we don't normally have the problem of trying to explain complicated problems of income taxation to jurors. . . .
>
> Well, this business about corporate reorganization is kind of a technical field in itself. I think that Congress appreciated the fact that many times businesses must readjust their method of operation by having different corporations in different states and some for international operations and so forth, and the Congress, in essence, has said that when there is a reorganization of a corporation for a legitimate purpose and after the reorganization things are about the same insofar as ownership and interest is concerned as they were before, well, there isn't going to be any kind of a tax from that kind of shifting around. So in essence they said if there is a legitimate reorganization of a corporation you don't have to pay any income tax on it; but if there is any shenanigans, so to speak, then the Government is going to look into it and you are going to have to pay an income tax on it. Now, that's not technically the way to say this but that's a layman's explanation of the situation. . . .
>
> So as I view the evidence, you should answer that question [whether the spin-off was a device for the distribution of earnings and profits] no, but, of course, I am not the jury and any thinking that I have about it or my observations or judgment are not in any way binding upon you at all. If you are convinced by the arguments of the able Government counsel and feel as he has urged you to feel, then have no hesi-

> tation in subscribing to his arguments and to the conclusion which he recommends for you. . . .
>
> Members of the jury, I see it's 20 minutes to 5:00. I suggest you go to your jury room and if you reach a verdict by 5:00 o'clock, fill in your form and the marshal will bring you back here. If you don't reach a verdict by 5:00 o'clock I suggest you deliberate until about 6:00 and then go to your homes and come back tomorrow at about 10:00 o'clock in the morning and continue your deliberations. If you reach a verdict, say tonight between 5:00 o'clock and 6:00 o'clock, fill in the form of verdict and give it to your foreman and let him put it in an envelope and put it in his pocket and then he and all of you should return to this court room at 2:00 o'clock tomorrow afternoon. . . .

The jury returned a pro-taxpayer verdict at 5:00 P.M. The court subsequently granted judgement to the government notwithstanding the verdict, 196 F. Supp 21 (D. Minn. 1961), but without re-examining the jury's determination on the issue submitted to it.

8. *Distributions of divested stock under antitrust decree.* In United States v. E. I. du Pont de Nemours & Co., 366 U.S. 316 (1961), the Court referred to the "harsh tax consequences" of a divestiture by du Pont of its General Motors stock under an antitrust decree, and a tax ruling on this subject is summarized by Mr. Justice Frankfurter in his dissenting opinion. There is a more complete discussion of this question in the District Court opinion. 177 F. Supp. 1, 17 et seq. (N.D. Ill. 1959). Why would §355 not apply to du Pont's distribution of its G.M. stock?

Section 1111, though it does not say so explicitly, was enacted to accommodate the du Pont divestiture. For §1111's legislative history, see 1962-1 C.B. 375-392.

9. *References.* Lyons, Some Problems in Corporate Separations Under the 1954 Code, 12 Tax L. Rev. 15 (1956); Young, Corporate Separations: Some Revenue Rulings Under Section 355, 71 Harv. L. Rev. 843 (1958); Caplin, The Five-Year Business Rule for Corporate Separations, 35 Taxes 381 (1957); Comment, Divisive Reorganizations Under the Internal Revenue Code of 1954, 67 Yale L.J. 38 (1957); Cordes, The Device of Divisive Reorganizations, 10 Kan. L. Rev. 21 (1961).

SECTION K. REINCORPORATIONS

REV. RUL. 61-156
1961-2 C.B. 62

Advice has been requested whether the transaction described below should be treated, for Federal income tax purposes, as a sale of corporate assets to a newly organized corporation followed by the liquidation of the "selling" corporation under sections 337 and 331 of the Internal Revenue Code of 1954, or whether the transaction should be treated as a reorganization within the meaning of section 368 of the Code.

Within a 12-month period following the adoption of a plan of complete liquidation, a corporation sold substantially all of its assets to a new corporation formed by the management of the selling corporation. The "purchasing" corporation paid 18,000*x* dollars for the assets as follows:

(a) 2,025*x* dollars in shares of its stock equal to 45 percent of all the shares to be issued,

(b) 4,975*x* dollars in long-term notes, and

(c) 11,000*x* dollars in cash obtained through a first mortgage borrowing on the assets acquired.

Immediately thereafter, the new corporation sold shares of its stock, equal to 55 percent of all the shares to be issued, to the public through underwriters.

The "selling" corporation was then completely liquidated, paying off its funded and unfunded liabilities and distributing the balance of its assets, in-

cluding the 45 percent stock interest in the purchasing corporation, the long-term notes, and cash to its shareholders. As a result of the transaction, the business enterprise continued without interruption in the corporate form with a subtantial continuing stock interest on the part of those persons who were shareholders in the selling corporation.

Section 1.331-1(c) of the Income Tax Regulations provides as follows:

> A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may, however, have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of "other property." See sections 301 and 356.

In this case, if the issuance of stock to the new investors is disregarded, there is clearly a mere recapitalization and reincorporation coupled with a withdrawal of funds. The withdrawal would be treated either under section 356(a) of the Code as "money or other property" received in connection with a reorganization exchange of stock for stock, or under section 301 of the Code as an unrelated distribution to the shareholders.

The issuance of stock to new investors can be disregarded as being a separate transaction, since even without it the dominant purpose — to withdraw corporate earnings while continuing the equity interest in substantial part in a business enterprise conducted in corporate form — was fully achieved. The issuance of stock to new investors was not needed to implement the dominant purpose and, therefore, the rest of the transaction was not fruitless without it and so dependent on it.

The transaction was shaped so as to make it essentially "a device whereby it has been attempted to withdraw corporate earnings at capital gains rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating" them. See Conference Report No. 2543, 83d Cong., to accompany H.R. 8300 (Internal Revenue Code of 1954), page 41.

It was not intended by Congress that such a device should obtain the benefits of section 337 and avoid dividend taxation. In substance there was no reality to the "sale" of corporate assets or to the "liquidation" of the selling corporation, since each was only a formal step in a reorganization of the existing corporation. The entire transaction was consummated pursuant to a plan of reorganization which readjusted interests in property continuing in a modified corporate form. Sections 1.368-1(b) and 1.368-2(g) of the regulations.

The newly formed "purchasing" corporation was utilized to effect, in substance, a recapitalization and a change in identity, form, or place of organization of the "selling" corporation and, at the same time, to withdraw accumulated earnings from the corporate enterprise for the benefit of the shareholders, while they nevertheless continued a substantial equity interest in the enterprise.

The fact that the shareholders of the "selling" corporation own only 45 percent of the stock of the "purchasing" corporation because of the public stock offering does not dispose of the reorganization question. A surrender of voting control, or ownership of less than 50 percent of the stock of a newly-formed corporation, does not in itself mark a discontinuity of interest. In John A. Nelson Co. v. Helvering, 296 U.S. 374 (1936), the Supreme Court of the United States held that there was a "reorganization" even though the shareholders of the acquired corporation received less than half of the stock of the acquiring corporation and received only nonvoting preferred stock therein. It is necessary only that the shareholders continue to have a definite and substantial equity interest in the assets of the acquiring corporation.

In view of the foregoing, it is held that the transaction here described constitutes a reorganization within the meaning of sections 368(a)(1)(E) and (F) of the Code. No gain or loss is recognized to the "selling" corporation on the exchange of property, as provided by section 361 of the Code. The basis of the assets in the hands of the "purchasing" corporation will be the same as in the hands of the "selling" corporation, as provided in section 362(b) of the Code. No gain or loss is recognized under section 354 of the Code on the exchange of the stock of the "selling" corporation for stock of the "purchasing" corporation pursuant to the plan of reorganization.

With regard to the stockholders' withdrawal of money and other property from the corporate solution, it is necessary to determine whether such withdrawal is to be treated as "boot" received as part of the consideration for their stock in the "selling" corporation in accordance with section 356(a) of the Code or as a separate dividend distribution taxable in accordance with the provisions of section 301 of the Code. See sections 1.301-1(l) and 1.331-1(c) of the regulations and Bazley v. Commissioner, 331 U.S. 737, rehearing denied and amended, 332 U.S. 752 (1947).

Under section 356(a)(1) of the Code, gain would be recognized to the shareholders of the "selling" corporation upon the surrender of their shares of stock in exchange for stock of the "purchasing" corporation, its long-term notes, cash, and other assets, but in an amount not in excess of the sum of cash and the fair market value of the long-term notes and other assets received. Under section 356(a)(2) of the Code, such gain would be taxable as a dividend to each shareholder to the extent of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913; the remainder, if any, would be treated as gain from the exchange of property. Under section 301 the distribution would be taxable as a dividend to the same extent as a dividend formally declared in the same amount.

In this case, viewing the issuance of stock of the "purchasing" corporation to new investors as a transaction separate from the reorganization, it is concluded that the distribution to stockholders of the "selling" corporation of the cash, long-term notes, and other assets should be treated as a distribution under section 301 of the Code.

In view of the conclusions reached herein, reconsideration has been given to Revenue Ruling 56-541, C.B. 1956-2, 189, which holds under similar circumstances that a nontaxable corporate sale of assets was effected under section 337 of the Code and that distributions to the shareholders were to be treated as in full payment in exchange for their stock under a plan of complete liquidation of the old corporation. The conclusions reached in the instant case are equally applicable to the question involved in Revenue Ruling 56-541. Accordingly, Revenue Ruling 56-541 is revoked.

Under authority of section 7805(b) of the Code, this Revenue Ruling will not be applied retroactively in any case in which transactions were consummated prior to August 21, 1961, in reliance on the Service's position as published in Revenue Ruling 56-541 and a retroactive application would be to the taxpayer's detriment.

NOTE

1. *Reincorporations.* In approaching Rev. Rul. 61-156, the student might consider the tax consequences of following naked reincorporation plan: the stock of XYZ, Inc., a successful corporation with a large earnings and profits account and highly appreciated assets, is inherited by A, Jr., on the death of his father. The date-of-death value

of the stock, and consequently its basis to A, Jr., is $2 million — the fair market value of the corporate assets. A, Jr., liquidates the corporation and, in accordance with a prearranged plan, transfers the assets to a newly organized corportion, taking in return all of its stock. If this transaction is respected as a liquidation under §331(a)(1) (on which no gain or loss is recognized because the fair market value of the assets received by A, Jr., is equal to the basis of his stock), followed by a non-taxable incorporation under §351, note the following results:

(a) The assets will acquire a stepped-up basis in the hands of the new corporation, equal to their fair market value at the time of liquidation.

(b) The old corporation's earnings and profits account will be obliterated, so that distributions to A, Jr., will constitute returns of capital (until the corporation's operations produce new earnings and profits), and the new corporation will have a clean slate so far as §531 (unreasonable accumulations) is concerned.

(c) The new corporation will be entitled to make elections as to such matters as accounting methods, accounting periods, depreciation methods, etc., unencumbered by the old corporation's elections and tax history.

Variations on the above plan could include the issuance to A, Jr., of debt as well as stock by the new corporation, thus laying a foundation for tax-free retirement of the debt from future earnings; or the issuance of preferred stock which would not constitute §306 stock because of the absence of earnings and profits. Another variation would be a transfer by a corporation of its operating assets to a newly organized subsidiary, followed by a complete liquidation of the old corporation. The shareholders would thus receive stock of the new operating corporation, plus the liquid or investment assets. (Section 355 would not have been open to the old corporation, assuming the existence of only one active business.)

If the plan were as bald as just described, it would no doubt be disregarded as a sham, or treated as a Type E or F reorganization, as Rev. Rul. 61-156 suggests. See Heller v. Commissioner, 2 T.C. 371 (1943). The proper treatment is not so obvious, however, if we assume a business purpose for the transaction, coupled with a change in ownership, or if the liquidation and reincorporation were separated by time and not prearranged (e.g., if the old corporation was liquidated because a proprietorship or partnership seemed a preferable business form, and reincorporation resulted from a genuine, unexpected change of plans).

2. *Implications of Rev. Rul. 61-156.* If the form of the transaction described in Rev. Rul. 61-156 had been respected, the shareholders of the old corporation would have recognized capital gain or loss, depending upon whether the value of the liquidating distribution exceeded or fell short of the basis of their shares. (Since this determination is made shareholder-by-shareholder, some might have incurred losses and others gains.) The "purchasing" corporation would have taken the assets at a basis equal to their "cost," and it would have commenced life with no earnings and profits. Is the Internal Revenue Service's view of the transaction *necessarily* disadvantageous to the shareholders and the new corporation? Could Rev. Rul. 61-156 aid the new corporation but be detrimental to some or all of the shareholders — or vice versa? If so, how is the last sentence of the ruling to be applied?

If the "reorganization" approach of the ruling is accepted, does it follow that the cash and notes received by the shareholders of the old corporation should be treated as a §301 distribution rather than as boot under §356? Note how the ruling's reliance on §301 escapes the "dividend-within-gain" limitation of §356(a)(2), under which boot constitutes a dividend only to the extent that the shareholder realizes a gain on the transaction (supra p. 702).

3. *Reincorporations before 1954 Code.* Before 1954, reincorporations were ordinarily attacked by the Internal Revenue Service as constituting Type D reorganizations (transfer by a corporation of all or part of its assets to a corporation controlled by transferor's shareholders). See Bard-Parker Co. v. Commissioner, 218 F.2d 52 (2d Cir. 1954) (two transfers were but procedural steps used to complete what, in substance, constituted a single transfer); Liddon v. Commissioner, 230 F.2d 231 (6th Cir. 1956) (accord); but see United States v. Arcade Co., 203 F.2d 230 (6th Cir. 1953) (separate steps honored). For unsuccessful attempts by taxpayers to avoid reorganization status under pre-1954 law

on the ground that the reincorporation-liquidation was not animated by a business purpose and hence did not meet the requirements of Regs. §1.368-2(g), see Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947); Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949).

The "Type D" reorganization approach to reincorporation was made more complicated in 1954, with the addition to §368(a)(1)(D) of the second clause, under which a transaction qualifies as a Type D reorganization only if it is coupled with a distribution of the transferee corporation's stock or securities in a transaction qualifying under §354, §355, or §356. The liquidation-reincorporation device does not qualify under §355, because it does not operate to divide the assets of the old corporation, and there may be other barriers to its qualifying under §355 as well (e.g., the two trade or business requirement). Qualification by virtue of §354 is possible only if substantially all of the old corporation's assets are transferred — see §354(b)(1)(A) — and this requirement creates difficulties if the shareholders of the old corporation retain or receive a significant part of the assets, as they did in some of the cases decided under pre-1954 law. (In this connection, consider whether §368(a)(1)(D) could have been persuasively invoked by Rev. Rul. 61-156.)

Because the pre-1954 case law on reincorporations was thought to supply inadequate protection against the bail-out of corporate earnings at the capital gain rate, the House Ways and Means Committee's version of the 1954 Code included a provision under which assets retained by the shareholders on reincorporating would be taxed as a dividend. A reincorporation was subject to the provision if more than 50 per cent of the old corporation's assets were transferred to a controlled corporation within 5 years after a liquidation, but an exception was provided for transactions not having tax avoidance as a principal purpose.

The House proposal was eliminated in conference, the conferees stating:

> The House bill in section 357 contained a provision dealing with a device whereby it has been attempted to withdraw corporate earnings at capital gains rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating the business assets. This provision gave rise to certain technical problems and it has not been retained in the bill as recommended by the accompanying conference report. It is the belief of the managers on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill.

This implied invitation to issue appropriate regulations was accepted by the Treasury Department. See Regs. §1.331-1(c) (quoted in Rev. Rul. 61-156); §1.301-1(l). For the judicial response to the conference committee's expression of confidence, see Grubbs v. Commissioner, 39 T.C. 42 (1962), and Gallagher v. Commissioner, 39 id. 144 (divided court, with extended discussion).

4. *Carryover of tax attributes in reorganizations under §381.* Revenue Ruling 61-156 invokes both §368(A)(1)(E) (recapitalization) and §368(A)(1)(F) (mere change in identity). Does it make a difference, so far as the transferee corporation's earnings and profits, accounting methods, basis, and other tax attributes are concerned, whether the transaction is viewed as a Type E reorganization, a Type F reorganization, or a sham? Section 381, enacted in 1954 to require the transferee corporation in most reorganizations to take over such tax attributes of the transferor corporation, does not embrace Type E reorganizations, presumably on the assumption that the recapitalized enterprise is the same corporation and that an explicit provision for a carryover of tax attributes is unnecessary.

5. *References.* Kuhn, Liquidation and Reincorporation Under the 1954 Code, 51 Geo. L.J. 96 (1962); Morrison, The Line Between Liquidations and Reorganizations, 41 Taxes 785 (1963); MacLean, Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group, 13 Tax L. Rev. 407 (1958); Rice, When Is a Liquidation Not a Liquidation for Federal Income Tax Purposes, 8 Stan. L. Rev. 208 (1956); Bauman, New Clouds on the Liquidation Horizon, 48 A.B.A.J. 182 (1962); Reese, Reorgan-

ization Transfers and Survival of Tax Attributes, 16 Tax L. Rev. 207 (1961); Lane, The Reincorporation Game: Have the Ground Rules Really Changed? 77 Harv. L. Rev. 1218 (1964).

SECTION L. COMBINING TWO OR MORE ENTERPRISES: MERGERS AND CONSOLIDATIONS

Section 354(a)(1) of the 1954 Code, providing for the nonrecognition of gain or loss on reorganization exchanges, is identical with §112(b)(3) of the 1939 Code.

Section 354(a)(2) of the 1954 Code, limiting the general rule of §354(a)(1) in certain cases, has no counterpart in the 1939 Code.

Section 354(b) of the 1954 Code, making §354(a)(1) inapplicable to divisive reorganizations, is new and is associated with §355.

Section 356 of the 1954 Code, relating to the receipt of "boot," is derived, with modifications, from §112(c) of the 1939 Code.

Section 368(a) of the 1954 Code, defining the term "reorganization," is derived, with modifications, from §112(g)(1) of the 1939 Code.

Section 368(b) and (c) of the 1954 Code, defining the terms "party to a reorganization" and "control" respectively, are similar to §112(g)(2) and 112(h) of the 1939 Code.

In the preceding sections of this chapter, we have been concerned primarily with readjustments of a single corporate enterprise. Section 351 permits the tax-free incorporation of an enterprise. It also authorizes the tax-free creation of a subsidiary, overlapping in this respect §§368(a)(1)(D) and 361(a). Section 331 deals with the complete or partial liquidation of a corporation; §332, with the complete liquidation of a subsidiary. Recapitalization of a corporation involves §§305 and 354. The material on spin-offs, split-offs, and split-ups was concerned with the division of an existing enterprise into several entities.

We now turn to the problem of combining two or more enterprises. Suppose, for example, that A Corp., a local department store, is to be acquired by B Corp., a national chain. The shareholders of A may simply sell their stock to B for cash or they may cause A to sell its assets to B for cash. The tax effects of either type of sale are not difficult to work out. Suppose, however, that the consideration is to be paid partly or entirely in stock or securities of the acquiring corporation. Then the following routes, among others, are open:

(a) A can be merged into B, stock or securities in B being issued to A's stockholders in exchange for their A stock. A variation on this plan would be a consolidation of A and B, stock or securities in the consolidated corporation being issued to the stockholders of both A and B. Either transaction is a "reorganization" by virtue of §368(a)(1)(A), and the exchange of stock by the stockholders is tax-free under §354.

(b) A's stockholders can transfer their stock to B in exchange for voting stock of B, A becoming a subsidiary of B. This is a reorganization under §368(a)(1)(B), and the stockholders' exchange is tax-free under §354. If desired, A could be liquidated by B under §332.

(c) A can transfer its assets to B in exchange for B's voting stock. This is a reorganization under §368(a)(1)(C), and A's exchange of its assets for B stock is tax-free under §361(a). A can be kept alive, as a holding company, or it can be liquidated as part of the reorganization. Such a liquidation would be a tax-free exchange under §354, since A's stockholders would exchange their A stock for the B stock.

(d) A and B could both transfer their assets to a newly organized corporation, C, in exchange for C stock. These transfers would be tax-free under §351. Both A and B would then be holding companies.

(e) The stockholders of A and B could transfer their A and B stock to a newly organized corporation, C, in exchange for C stock. These transfers would qualify under §351. C would then be a holding company.

The illustration above involves the combination of two previously unrelated businesses into a single corporate entity or hierarchy, but combinations of previously related entities are also common. Indeed, we have already encountered an example of such a transaction: the liquidation of a subsidiary under §332. But the more elaborate methods of effecting a combination described above could also be adapted for use in combining two or more enterprises that were already affiliated in one way or another.

Some of the problems that may arise in acquisitions of the type just described are considered in the material that follows. As has already been seen in our consideration of other aspects of the reorganization provisions of the Code, however, their history hangs heavy over our head.

CORTLAND SPECIALTY CO. v. COMMISSIONER

60 F.2d 937 (2d Cir. 1932)

[The taxpayer, engaged in the business of buying and selling petroleum products, entered into an agreement with the Deyo Oil Company, whereby it was to transfer 91½ per cent of its net assets to Deyo (retaining the balance of its assets to take care of liabilities) and go out of business. The taxpayer's sole stockholder was thereupon to become Deyo's general manager in the territory previously served by the taxpayer. Deyo was to pay about $77,000 in cash and about $160,000 in promissory notes (with serial maturities of which the longest was fourteen months) for the transferred assets.]

Before L. HAND, AUGUSTUS N. HAND, and CHASE, Circuit Judges.

AUGUSTUS N. HAND, Circuit Judge.

The question raised by this appeal is whether the transfer by Cortland Specialty Company to Deyo Oil Company, Inc., hereinafter described was a reorganization within the meaning of §203(h)(1) of the Revenue Act of 1926, which relieved the Cortland Company from paying an income tax upon any gain that might result therefrom, or whether the transfer was a mere sale which subjected the transferor to a tax on any profit which is realized. . . .

It may be said at the outset that the contract of Cortland with Deyo and the corporate resolution authorizing it to be made treat the transfer to the latter as a sale. The instrument begins by reciting that Cortland "has determined . . . to sell and dispose of all its physical and tangible assets," and that Deyo "has determined to purchase said assets." It goes on to say that Cortland "agrees to sell, transfer and convey . . . all and singular its real property, interests in real property, leases of real property . . . and equipment . . ." and later to say that it "shall sell . . . all of the merchantable gasoline, kerosene, oils and other petroleum products," and that Deyo "agrees to pay" the "purchase price of $213,000.00" for the "real property . . . and equipment" and a further "purchase price" to be determined by "an inventory taken at prevailing cost prices" for the "petroleum products." Nothing is said about the acquisition of any vested interest by Cortland or its stockholders in the business or assets of Deyo, but, on the contrary, it is provided that their interest shall be completely severed for, under article fifth of the contract, Cortland is "not to engage in the business of buying, selling or dealing in gasoline, kerosene or other petroleum products from and after October 1st,

1925," and is to receive nothing but cash and short time promissory notes as the consideration for the business and property sold. The transaction certainly bore all the characteristics of a simple sale.

But it is argued that under subdivisions (e) and (e)(1) of §203 of the Revenue Act of 1926, "no gain or loss shall be recognized if a corporation a party to a reorganization" distributes "stock or securities" and "money" "in pursuance of the plan of reorganization," and that under subdivision (h)(1)(A) of the section of the act, the term "reorganization" is defined broadly enough to exempt Cortland from a profit tax on its transfer. In subdivision (h)(1)(A) a reorganization is defined as *"a merger or consolidation,"* and the subdivision goes on to say that "merger or consolidation" *include* "the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation." If the last clause means that any transfer of "substantially all the properties" of one corporation to another corporation is a reorganization, the position of Cortland is strong; but we do not regard such an interpretation as warranted.

Reorganization, merger, and consolidation are words indicating corporate readjustments of existing interests. They all differ fundamentally from a sale where the vendor corporation parts with its interest for cash and receives nothing more. Reorganization in the most ordinary sense suggests "the formation of a new corporation [by the creditors and shareholders of a corporation] that is in financial difficulties, for the purpose of purchasing the company's works and other property, after the foreclosure of a mortgage or judicial sale." Morawetz Corp. §812; Symmes v. Union Trust Co. (C.C.) 60 F. 830. While the term includes financial readjustments in ways other than by judicial sale, it does not properly embrace mere purchases by one company of the assets of another. Little Rock Chamber of Commerce v. Reliable Furniture Co., 138 Ark. 403, 211 S.W. 371. Reorganization is defined in subdivisions (h)(1)(A) as including "a merger or consolidation." A merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist, and the merging corporation alone survives. A consolidation involves a dissolution of the companies consolidating and a transfer of corporate assets and franchises to a new company. In each case interests of the stockholders and creditors of any company which disappears remain and are retained against the surviving or newly created company. . . . Undoubtedly such statutes vary in the different states particularly in respect to how far the constitutent companies may be deemed to survive the creation of the new or modified corporate structure, but we believe that the general purpose of them all has been to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form. A sale of the assets of one corporation to another for cash without the retention of any interest by the seller in the purchaser is quite outside the objects of merger and consolidation statutes.

Section 203 of the Revenue Act of 1926 must be interpreted in this setting. Its purpose was to relieve those interested in corporations from profits taxes in cases where there was only a change in the corporate form in which business was conducted without an actual realization of any gain from an exchange of properties. When describing the kind of change in corporate structure that permits exemption from these taxes, §203 does not disregard the necessity of continuity of interests under modified corporate forms. Such is the purpose of the word "reorganization" in section 203(b)(3) of the act, where a corporation exchanges its property "solely for stock or securities." Such also is the nature of the "merger or consolidation" described in subdivision (h)(1)(A) where a corporation acquires

a majority of the stock of another, and such is the nature of the "reorganization" described in subdivision (h)(1)(B) of section 203, where a corporation transfers assets to another corporation, and the transferor, or its stockholders, immediately thereafter are in control of the transferee. The words "A recapitalization," in subdivision (h)(1)(C) of section 203, and "A mere change in . . . form . . . of organization, however effected," in subdivision (h)(1)(D) of §203, involve the same idea.

When subdivision (h)(1)(A) included in its definition of "merger or consolidation" the "acquisition by one corporation of . . . substantially all the properties of another," it did this so that the receipt of property by the corporation surviving the merger might serve to effect a reorganization as does an acquisition of stock. Each transaction presupposed a continuance of interest on the part of the transferor in the properties transferred. Such a limitation inheres in the conventional meaning of "merger and consolidation," and is implicit in almost every line of section 203 which we have quoted. In Pinellas Ice & Cold Storage Co. v. Commissioner, 57 F.(2d) 188, the Court of Appeals of the Fifth Circuit decided that a transaction almost exactly like the present was not a "merger or consolidation," but a mere sale carrying no exemption. Judge Groner's opinion in Corbett v. Burnet, 50 F.(2d) 492, is in accord. In defining "reorganization," §203 of the Revenue Act gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms.

Furthermore the Cortland Company cannot come within the exception to the general rule that gains realized from exchanges of property represent taxable income unless §203(e) and §203(e)(1) apply. Under those clauses, even if the transfer to Deyo was an exchange in pursuance of a "plan of reorganization," the property received by Cortland had to include *some* "stock or securities" (§203(e)), or the exemption could not be had. As no stock was issued against the transfer, the conditions for an exemption were not fulfilled unless the notes, all payable within fourteen months of the date of the transfer, and all unsecured, can be considered "securities" under §203(e). Inasmuch as a transfer made entirely for cash would not be enough, it cannot be supposed that anything so near to cash as these notes payable in so short a time and doubtless readily marketable would meet the legislative requirements.

The very reason that §203(e) requires that some of the property received in exchange should be *"stock or securities"* is to deprive a mere sale for cash of the benefits of an exemption and to require an amalgamation of the existing interests. There can be no justice or propriety in taxing one corporation who transfers its properties for cash and in relieving another that takes part of its pay in short time notes. The situation might be different had the "securities," though not in stock, created such obligations as to give creditors or others some assured participation in the properties of the transferee corporation. The word "securities" was used so as not to defeat the exemption in cases where the interest of the transferor was carried over to the new corporation in some form. . . .

The orders of the Board of Tax Appeals are affirmed.

NOTE

1. *Type of consideration permitted in Type C reorganizations under current law.* After the *Cortland Specialty Co.* case was decided, the statutory definition of "reorganization" was amended. Under the statute as it stands today, a corporation that transfers

substantially all its assets to another corporation is permitted to receive *only voting stock* of the transferee corporation (or of a corporation in control of the transferee), except that (as a result of an amendment in 1954) not more than 20 per cent of the property can be acquired for other property or money. §368(a)(1)(C) and 368(a)(2)(B). The requirement that at least 80 percent of the assets be acquired for voting stock is in effect a statutory guarantee that the transferor will have a continuing interest in the transferred assets. Although the statute itself has thus to some extent taken over the protective function of the judicially created doctrine of "continuity of interest," it remains important in a variety of contexts, as will be seen hereafter.

2. *"Continuity of interest."* The decision of the Court of Appeals in the *Pinellas* case, cited in the opinion above, was affirmed by the Supreme Court. Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933). The following excerpt is important:

> The "vendor" agreed "to sell," and "the purchaser" agreed "to purchase," certain described property for a definite sum of money. Part of this sum was paid in cash; for the balance the purchaser executed three promissory notes, secured by the deposit of mortgage bonds, payable, with interest, in about forty-five, seventy-five, and one hundred and five days, respectively. These notes — mere evidences of obligation to pay the purchase price — were not securities within the intendment of the act and were properly regarded as the equivalent of cash. It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price accepts well secured, short-term notes (all payable within four months), when another who makes a like sale and receives cash certainly would be taxed. . . .
>
> Certainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes. [287 U.S. at 468-470.]

Two years later the Supreme Court held that a transfer of substantially all the assets of a corporation for voting trust certificates (worth about $540,000), representing 18,000 shares of common stock of another corporation, plus about $425,000 in cash was a "reorganization" under the statute applicable to the year in question. After repeating the last sentence of the foregoing quotation from its opinion in the *Pinellas* case, the Court went on:

> And we now add that this interest must be definite and material; it must represent a substantial part of the value of the thing transferred. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation. . . .
>
> The transaction here was no sale, but partook of the nature of a reorganization, in that the seller acquired a definite and substantial interest in the purchaser.
>
> True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the statute. Also, a large part of the consideration was cash. This, we think, is permissible so long as the taxpayer received an interest in the affairs of the transferee which represented a material part of the value of the transferred assets. [Helvering v. Minnesota Tea Co., 296 U.S. 378, 385-386 (1935).]

How long must the continuity of interest last? See Campbell v. Commissioner, 15 T.C. 312 (1950).

It was pointed out above that in a Type C reorganization under the present statute, at least 80 per cent of the assets must be acquired for voting stock. In the *Minnesota Tea* case, supra, the "continuity of interest" doctrine was held to be satisfied by a transfer for $540,000 in voting trust certificates (representing common stock in the transferee) and $425,000 in cash. A fortiori a transfer solely for voting stock would have qualified. But *does* the transferor have a "definite and material interest" in the transferee, representing "a substantial part of the value of the thing transferred," if he owns an insubstantial fraction of the stock of a national company? Minnesota Tea's stake

in Grand Union, its transferee, was 7¾ per cent of the outstanding stock. This fact caused the Board of Tax Appeals to comment:

> Thus the transaction appears to be far from a continuing interest in the same property through a mere change in forms of ownership but rather an almost complete change in the essential assets owned. . . . [28 B.T.A. 591, 595 (1933).]

Transactions of this kind pose two questions of policy: Is the transfer a sale in substance if the transferor gets stock (or, if a merger or consolidation is used, stock and/or securities) of a national corporation representing a relatively minor, marketable interest in an enterprise whose financial stability is almost totally independent of the newly acquired assets? More broadly, do the reorganization provisions contribute toward a concentration of industrial and mercantile enterprise that the antitrust laws and other national policies are designed to discourage? If so, can transactions of this type be effectively differentiated for tax purposes from the combination of two enterprises of approximately equal size, where the formerly independent proprietors still have a substantial stake in their old assets and where the combination does not measurably contribute to a concentration of economic power?

The House version of the 1954 Code distinguished between closely held and publicly held corporations by allowing publicly held corporations to obtain the tax advantages of the reorganization provisions by any statutory merger or consolidation that qualified under state law, but requiring closely held corporations to meet other qualifications as well. The reason for imposing greater restrictions on closely held corporations was stated in the House Report (p. 39) as follows:

> Publicly held corporations usually have a corporate existence separate from that of their shareholders and as a rule do not merge or consolidate with a view to the tax advantages which may result therefrom at the shareholder level. There is ample evidence, however, that closely held corporations may undertake these transactions solely in the hope of distributing earnings to shareholders at capital gains rates.

The Senate rejected the proposal, saying (S. Rept., p. 42):

> Not only is it difficult, if not impossible, to formulate satisfactory definitions as to the types of corporations which will be deemed "publicly held" or "closely held" for tax purposes, but there is considerable doubt as to whether it would be sound policy for the tax laws to impose greater restrictions on a class of corporations which is ordinarily small than on their larger competitors.

3. *Use of non-qualifying consideration in Type B and C reorganizations.* Section 368(a)(1)(B) defines a Type B reorganization as an acquision of stock in exchange *solely* for voting stock of the acquiring corporation. What if voting stock is not the sole consideration, e.g., the acquiring corporation gives cash, non-voting stock, or debentures, as well as voting stock? For many years, the cognoscenti assumed that the transaction was not a "reorganization." True, §354(a)(3) contains a cross reference to §356, which in turn provides rules for dealing with "boot" — but it was generally thought that these rules took hold only if the transaction was a "reorganization" and that this threshold question was to be answered by looking solely to the definitions of §368(a)(1) (or the corresponding provisions of prior law). Consequently, there was much fluttering in the dovecotes when Howard v. Commissioner, 238 F.2d 943 (7th Cir. 1956), held that "boot" could be disregarded in determining whether the transaction was a reorganization, and even more when the Tax Court endorsed this decision in Turnbow v. Commissioner, 32 T.C. 646 (1959). *Turnbow* was reversed on appeal, however, in an opinion which extensively reviewed the legislative history of the reorganization provisions, 286 F.2d 669 (9th Cir. 1960). The court pointed out that the *Howard* theory would be equally applicable to Type C reorganization; and that if it were correct, the final clauses of §368(a)(1)(C) and §368(a)(2)(B) would be surplusage. The taxpayer argued that if Type B reorganization status could be defeated by adding cash or debentures to voting stock as consideration, taxpayers would be able to arrange for the recognition of losses by using a trifling amount of boot; the court thought that such a transaction might be defeated

by other parts of §368(a)(1) (without specifying which ones) and that, in any event, this was a matter for Congress. Is there a basis for ignoring trivial amounts of cash, if paid in order to lay the basis for deducting a loss on the transfer of depreciated stock in such transactions?

The Supreme Court granted certiorari in the *Turnbow* case, and affirmed the Court of Appeals, 368 U.S. 337 (1961).

For applications of *Turnbow,* see Mills v. Commissioner, 331 F.2d 321 (5th Cir. 1964) (cash paid to avoid issuing fractional shares in stock-for-stock acquisition does not disqualify transaction as Type B reorganization); Lutkins v. United States, 312 F.2d 803 (Ct. Cl. 1963) (use of cash in acquiring stock; held, not a Type B reorganization). See also Randall, Income Tax Consequences of Boot in Section 368(a)(B) Stock for Stock Reorganizations, 71 Yale L.J. 1316 (1962).

If cash is required to eliminate fractional shares, pay off dissenters, defray reorganization expenses, etc., what can be done in a Type B or C reorganization to achieve these ends without violating the restrictions of §368(a)(1)(B) and (C)?

Note that the type of consideration that may be employed in a Type A reorganization (statutory merger or consolidation) is not specified by §368(a)(1)(A).

4. *Use of parent's stock in Type B and C reorganizations.* Before 1954, the acquiring corporation in a Type B or C reorganization could issue only its own stock as consideration for the stock or assets of the other corporation. See Groman v. Commissioner, 302 U.S. 82 (1937); Helvering v. Bashford, 302 U.S. 454 (1937); Mellon v. Commissioner, 12 T.C. 90 (1949). In 1954, the definition of the Type C reorganization was amended by adding the parenthetical phrase of §368(a)(1)(C), to permit use of stock of the parent of the acquiring corporation, and a companion change in §368(c) provides that the parent is a "party to the reorganization" so that its stock will qualify for non-recognition under §354. See also Rev. Rul. 64-73, 1964-10 I.R.B. 11 (assets acquired for stock of L but transferred to L's subsidiary M and M's subsidiary N; held, a Type C reorganization). In 1964, similar statutory changes were made to permit the use of the stock of a parent corporation in a Type B reorganization.

An alternative route to the same result is afforded by §368(a)(2)(C), which permits a corporation to acquire the stock or assets for its own stock, and then to transfer the acquired stock or assets to a subsidiary.

5. *Type B reorganizations and "creeping control."* Does §368(a)(1)(B) embrace every acquisition of stock for voting stock of the acquiring corporation, no matter how small, provided the acquiring corporation has control (defined by §368(c) to mean 80 per cent of voting power and 80 per cent of non-voting shares by number) immediately after the acquisition? See McDonald and Willard, Tax Free Acquisitions and Distributions, 14 N.Y.U. Inst. on Fed. Taxation 859, 871-876 (1956).

6. *"Substantially all of the properties" in Type C reorganizations.* The acquiring corporation in a Type C acquisition must take over "substantially all of the properties" of the acquired corporation. In Rev. Rul. 57-518, 1957-2 C.B. 253, the Internal Revenue Service expressed the view that this phrase could not be translated into a specific percentage, but that "the nature of the properties retained by the transferor, the purpose of the retention, and the amount thereof" were among the elements to be weighed. In the case to which the ruling was directed, the transferor retained cash, accounts receivable, notes, and 3 per cent of its inventory, with an aggregate value about equal to its liabilities, and used these assets to discharge its liabilities; the Service ruled that this was consistent with §368(a)(1)(C)'s requirement that "substantially all of the [transferor's] properties" be transferred.

Whether the acquiring corporation has received "substantially all of the properties" of the other corporation is ordinarily determined as of the time of the transfer. If the acquiring corporation was not interested in acquiring all of the assets, however, and some were distributed or disposed of by the transferor corporation in anticipation of a Type C reorganization, the comparison may be made as of the time the plan was put into action, especially if the anticipatory disposition was tax-free. See Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1937), cert. denied, 305 U.S. 605 (1938); Mellon v. Commissioner, 12 T.C. 90 (1949), aff'd on other grounds, 184 F.2d 157 (3d Cir. 1950).

7. *References.* Darrell, The Use of Reorganization Techniques in Corporate Acquisi-

tions, 70 Harv. L. Rev. 1183 (1957); Leake, Problems in Corporate Acquisitions, 13 Tax L. Rev. 67 (1957); Kumler, How to Reorganize a Small Corporation into a Larger One, 1956 So. Calif. Tax Inst. 445 (a case study); Lurie, Namorg — or *Groman* Revisited, 10 Tax L. Rev. 119 (1954); Fager, The Acquisition of Partly-Held Corporations, 18 N.Y.U. Inst. on Fed. Taxation 799 (1960); Johnson, Reorganizations — Minority Shareholders, Including Dissenters, 18 id. 821; Goldman, The C Reorganization, 19 Tax L. Rev. 31 (1963).

On the basic policy issues, see Hellerstein, Mergers, Taxes, and Realism, 71 Harv. L. Rev. 254 (1957); Dane, The Case for Nonrecognition of Gain in Reorganization Exchanges, 36 Taxes 244 (1958); Sandberg, The Income Tax Subsidy to "Reorganization," 38 Colum. L. Rev. 98 (1938); Butters, Lintner, and Cary, Effects of Taxation: Corporate Mergers (1951).

For overviews of the reorganization and related provisions of the Code, with proposals for legislative changes, see Brown, An Approach to Subchapter C, 3 Tax Revision Compendium (House Ways and Means Committee, 1959) 1619; articles by Peterson, Calkins, and Lewis, id. at 1611-1652; Surrey, Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project — A.B.A. Committee Study on Legislative Revision, 14 Tax L. Rev. 1 (1958); Advisory Group on Subchapter C (House Ways and Means Committee), Revised Report (1958).

LeTULLE v. SCOFIELD

308 U.S. 415 (1940), rehearing denied, 309 U.S. 694

Mr. Justice Roberts delivered the opinion of the Court.

We took this case because the petition for certiorari alleged that the Circuit Court of Appeals had based its decision on a point not presented or argued by the litigants, which the petitioner had never had an opportunity to meet by the production of evidence.

The Gulf Coast Irrigation Company was the owner of irrigation properties. Petitioner was its sole stockholder. . . . November 4, 1931, the Irrigation Company, the Gulf Coast Water Company, and the petitioner, entered into an agreement which recited that the petitioner owned all of the stock of the Irrigation Company; described the company's properties, and stated that, prior to conveyance to be made pursuant to the contract, the Irrigation Company would be the owner of certain other lands and irrigation properties. . . . The contract called for a conveyance of all the properties owned, and to be owned, by the Irrigation Company for $50,000 in cash and $750,000 in bonds of the Water Company, payable serially over the period January 1, 1933, to January 1, 1944. The petitioner joined in this agreement as a guarantor of the title of the Irrigation Company and for the purpose of covenanting that he would not personally enter into the irrigation business within a fixed area during a specified period after the execution of the contract. . . .

The contract between the two corporations was carried out November 18, with the result that the Water Company became owner of all the properties then owned by the Irrigation Company. . . . The [Irrigation Company] reported no gain for the taxable year in virtue of its receipt of bonds and cash from the Water Company. The Commissioner of Internal Revenue assessed additional taxes . . . against the petitioner as transferee of the Irrigation Company's assets in virtue of the gain realized by the company on the sale of its property. The tax was paid and claims for refund were filed. . . . The respondent's contention that the transaction amounted merely to a sale of assets by the petitioner and the Irrigation Company and did not fall within the statutory definition of a tax-free reorganization was overruled by the District Court and judgment was entered for the petitioner.

The respondent appealed, asserting error on the part of the District Court in matters not now material and also assigning as error the court's holding that the transaction constituted a nontaxable reorganization.

The Circuit Court of Appeals concluded that, as the Water Company acquired substantially all the properties of the Irrigation Company, there was a merger of the latter within the literal language of the statute, but held that, in the light of the construction this Court has put upon the statute, the transaction would not be a reorganization unless the transferor retained a definite and substantial interest in the affairs of the transferee. It thought this requirement was satisfied by the taking of the bonds of the Water Company, and, therefore, agreed with the District Court that a reorganization had been consummated. It added, however, "We find a reason for reversing the judgment which has not been argued."

[Explanation of the Court of Appeals' reason for reversing the District Court is omitted.]

We find it unnecessary to consider petitioner's contention that the Circuit Court of Appeals erred in deciding the case on a ground not raised by the pleadings, not before the trial court, not suggested or argued in the Circuit Court of Appeals, and one as to which the petitioner had never had the opportunity to present his evidence, since we are of opinion that the transaction did not amount to a reorganization and that, therefore, the petitioner cannot complain, as the judgment must be affirmed on the ground that no tax-free reorganization was effected within the meaning of the statute.

[Section 112(i), Revenue Act of 1928] provides, so far as material:

(1) The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation) . . .

As the court below properly stated, the section is not to be read literally, as denominating the transfer of all the assets of one company for what amounts to a cash consideration given by the other a reorganization. We have held that where the consideration consists of cash and short term notes the transfer does not amount to a reorganization within the true meaning of the statute, but is a sale upon which gain or loss must be reckoned. Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462. We have said that the statute was not satisfied unless the transferor retained a substantial stake in the enterprise and such a stake was thought to be retained where a large proportion of the consideration was in common stock of the transferee, Helvering v. Minnesota Tea Co., 296 U.S. 378, or where the transferor took cash and the entire issue of preferred stock of the transferee corporation. John A. Nelson Co. v. Helvering, 296 U.S. 374. And, where the consideration is represented by a substantial proportion of stock, and the balance in bonds, the total consideration received is exempt from tax under [§112(b)(4) and 112(g), Revenue Act of 1928]. See Helvering v. Watts, 296 U.S. 387.

In applying our decision in the *Pinellas* case, supra, the courts have generally held that receipt of long term bonds as distinguished from short term notes constitutes the retention of an interest in the purchasing corporation. There has naturally been some difficulty in classifying the securities involved in various cases.

We are of opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee; and we do not think that the fact referred to by the Circuit Court of Appeals, that the

bonds were secured solely by the assets transferred and that, upon default, the bondholder would retake only the property sold, changes his status from that of a creditor to one having a proprietary stake, within the purview of the statute.

We conclude that the Circuit Court of Appeals was in error in holding that, as respects any of the property transferred to the Water Company, the transaction was other than a sale or exchange upon which gain or loss must be reckoned in accordance with the provisions of the revenue act dealing with the recognition of gain or loss upon a sale or exchange. . . .

The judgment of the Circuit Court of Appeals is affirmed and the cause is remanded to the District Court with directions to proceed in accordance with the opinion and mandate of the Circuit Court of Appeals.

So ordered.

Affirmed and remanded.

NOTE

1. *"Continuity of interest" and the creditor.* The record in LeTulle v. Scofield does not include a balance sheet for the Water Company. If the bonds received by the transferor represented a substantial part of the Water Company's liabilities, should not the continuity of interest doctrine be regarded as satisfied? Contrast, as to "continuity of interest," these possibilities for the owner of a one-man corporation:

(a) A statutory merger in which the individual exchanges his stock for $500,000 of bonds in the successor corporation whose balance sheet is as follows:

Assets	$1,000,000	Bonds	$500,000
		Common stock (stated capital plus surplus	500,000
	$1,000,000		$1,000,000

(b) A statutory merger in which the transferor exchanges his stock for $500,000 (market value) of stock in the successor whose balance sheet looks like this:

Assets	$25,000,000	Bonds	$15,000,000
		Common stock (stated capital plus surplus)	10,000,000
	$25,000,000		$25,000,000

Do the bonds in (a), or the stock in (b), confer the more substantial, definite, and material interest in the transferred assets?

If a corporation's capital structure is "thin," do its "creditors" have a proprietary interest for reorganization purposes?

In John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935), approved in the *LeTulle* case, the Court found that a transfer of substantially all of a corporation's property for $2,000,000 in cash plus non-voting preferred stock of the transferee worth (apparently) $1,250,000 qualified as a "reorganization." In Helvering v. Watts, 296 U.S. 387 (1935), also approved in the *LeTulle* case, a transfer of all the stock of a corporation for $1,000,000 of the transferee's common stock and about $1,200,000 of bonds of the transferred corporation guaranteed by the transferee was held to be a "reorganization."

2. *Current importance of LeTulle v. Scofield.* Like the *Cortland Specialty Co.* case, supra page 723, *LeTulle* is concerned with a transaction that would not meet the standards of §368(a)(1)(C) of current law, which requires that at least 80 per cent of the assets be acquired for voting stock of the acquiring corporation. But the issue in *LeTulle* can arise in other transactions that meet the literal requirements of §368(a)(1)(A) (statutory mergers and consolidations), as the case that follows indicates.

ROEBLING v. COMMISSIONER

143 F.2d 810 (3d Cir. 1944)

Before JONES and MCLAUGHLIN, Circuit Judges, and KALODNER, District Judge.

KALODNER, District Judge.

This appeal presents three questions: (1) Whether the transaction hereafter stated between a lessor corporation and a lessee corporation constituted a "statutory merger," within the meaning of [§368(a)(1)(A)]; (2) whether the doctrine of "continuity of interest" as enunciated in LeTulle v. Scofield, 308 U.S. 415, applies to a "statutory merger," and (3) whether under the facts a "continuity of interest" actually existed.

Taxability on gain resulting to the petitioner on the exchange of stock in the lessor corporation for bonds of the lessee corporation under the provisions of §112(b)(3) of the Revenue Act of 1938 depends on the disposition of the issues above stated.*

The facts are all stipulated. Summarized they are as follows:

Petitioner, an individual residing in Trenton, New Jersey, filed a Federal income tax return for the calendar year 1938 with the Collector of Internal Revenue for the First District of New Jersey.

On December 5, 1935, petitioner acquired by gift 166 shares of the stock of South Jersey Gas, Electric and Traction Co. (hereinafter referred to as South Jersey). This stock had been acquired by petitioner's donor on March 12, 1914, at a cost of $16,600.

South Jersey was a corporation organized on August 31, 1900, under the laws of the State of New Jersey, for the purpose of furnishing electricity and gas for public and private use in that state.

In June, 1903, South Jersey had leased all its franchises, plants and operating equipment to Public Service Corporation of New Jersey for 900 years. The lessee was to pay rent which beginning December 1, 1908, amounted to $480,000 per annum. In addition the lessee agreed to pay the interest charges on the lessor's bonded indebtedness, all taxes, insurance and such sums as were necessary to maintain, repair, improve and extend the leased properties. *All replacements and additions became the property of South Jersey subject to the terms of the lease.*

The lease further provided that *upon default of the terms of the lease* for a period of 30 days, after notice, *South Jersey could terminate the lease, reenter and reacquire the property and additions and extensions thereto.*

Under the terms of the lease South Jersey could enter upon the leased property for the purpose of inspecting it and determining its condition and the character of the management and whether the covenants of the lease were being complied with.

In July, 1924, this lease was assigned by Public Service Corporation of New Jersey to Public Service Electric and Gas Company which assumed the obligations thereof. . . .

Public Service Electric and Gas Company as a part of its unified electrical system held and operated under long-term leases the properties of many other utility companies. For more than ten years Public Service and its parent, Public Service Corporation of New Jersey, had engaged in a systematic effort to acquire the fee to these properties, and by 1927 had acquired more than two-thirds of the stock of certain of these lessor companies.

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* Section 112(b)(3) of the 1938 Act corresponded to §354(a)(1) of the 1954 Code. The restriction of §354(a)(2) was not enacted until 1954; had it been in effect for the taxable year involved in *Roebling*, it would have altered the result. — ED.

On May 10, 1937, the directors of South Jersey and of Public Service Electric and Gas Company adopted a "Plan of Reorganization" under which it was proposed that the former company be merged into the latter in accordance with the statutes of New Jersey. This plan provided that the stockholders of South Jersey (other than Public Service Electric and Gas Company) should exchange, dollar for dollar, their stock in South Jersey for 8 per cent one hundred years first mortgage bonds of Public Service Electric and Gas Company. These bonds were to be issued under a prior mortgage of Public Service Electric and Gas Company dated August 1, 1924, and under a supplemental indenture later to be executed. It was expressly provided in the "Agreement of Merger" executed on the same day: "The capital stock of the Public Service Electric and Gas Company . . . will not be changed by reason of this agreement." . . .

The "Agreement of Merger" was consummated pursuant to its provisions. In accordance therewith the taxpayer received in exchange for his 166 shares of stock in South Jersey, $16,600, principal amount of 8 per cent bonds which on November 25, 1938, had a fair market value of $34,777.

The Commissioner determined that the difference between the basis of the taxpayer's stock in South Jersey and the fair market value of the bonds received in exchange therefor must be recognized as taxable income in 1938 and he asserted a deficiency which the Tax Court sustained, so far as it was based upon this item.

The issues presented here arise by reason of taxpayer's contention (1) that the merger of South Jersey into Public Service Electric and Gas Co. was a "true statutory merger" under the laws of the state of New Jersey and therefore the exchange of stock for bonds was not a taxable event under §112 of the Revenue Act of 1938; (2) that since there was a "true statutory merger" the "continuity of interest" doctrine in the LeTulle v. Scofield case is inapplicable and (3) that in any event a "continuity of interest" actually existed in the instant case.

As to the taxpayer's first two contentions, which may be considered together: The admitted fact that the merger of the two corporations was a "true statutory merger" under the New Jersey law is not dispositive of the question as to whether there was a "statutory merger" here within the meaning of [§368(a)(1)(A). It is well-settled that a State law cannot alter the essential characteristics required to enable a taxpayer to obtain exemption under the provisions of a Federal Revenue Act.

We so held in Commissioner v. Gilmore's Estate, 3 Cir., 130 F.2d 791. Indeed that case is completely dispositive of the taxpayer's first two contentions. In *Gilmore's Estate* we found that though there was, in that case, a "true statutory merger" under the identical laws of New Jersey involved here, (1) such "true statutory merger" is insufficient without more to qualify as a "reorganization" under the Revenue Act, and (2) that a "continuity of interest" as enunciated in numerous decisions of the Supreme Court of the United States and [Regs. §1.368-1(b)] must still be present to establish a true reorganization. In *Gilmore's Estate* we said, on page 794:

> It is now settled that whether a transaction qualifies as a reorganization under the various Revenue Acts *does not turn alone upon compliance with the literal language of the statute.* The judicial interpretation has determined that something more may be needed and that, indeed, under some circumstances, something less will do. Our concern in this case is the "something more" since we have concluded that there was a literal compliance. . . .
>
> The reorganization provisions were enacted to free from the imposition of an income tax purely "paper profits or losses" wherein there is no realization of gain or loss in the business sense *but merely the recasting of the same interests in a different form,* the tax being postponed to a future date when a more tangible gain or loss is realized. . . . (emphasis supplied)

Morgan Manufacturing Co. v. Commissioner, 4 Cir., 124 F.2d 602, is in agreement with our ruling in *Gilmore's Estate.* In Helvering v. Alabama Asphaltic Limestone Co., 1942, 315 U.S. 179, at 182, the Supreme Court of the United States succinctly stated the rule as follows:

> From the *Pinellas* case, Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, to the *LeTulle* case, LeTulle v. Scofield, 308 U.S. 415, it has been recognized that a transaction may not qualify as a "reorganization" under the various revenue acts though the literal language of the statute is satisfied. See Paul, Studies in Federal Taxation (3d Series), p. 91 et seq. The *Pinellas* case introduced the continuity of interest theory to eliminate those transactions which had "no real semblance to a merger or consolidation" (287 U.S. page 470) and to avoid a construction which "would make evasion of taxation very easy." . . .

In view of the cases cited we cannot subscribe to the taxpayer's contention that under [§368(a)(1)(A)] the requirements of New Jersey law supersede the "continuity of interest" test as applied in LeTulle v. Scofield and the numerous other decisions.

The taxpayer's remaining contention that the requisite "continuity of interest" is present under the peculiar facts in this case is premised on a rather novel theory. He urges that "prior to the merger, the stockholders of South Jersey had *no proprietary interest* in its properties in any real sense," and that in sanctioning the merger "the decision of the New Jersey courts recognized that the stock in the lessor companies was substantially equivalent to a perpetual 8 per cent bond."

This contention places the taxpayer in an anomalous position. Whereas the "continuity of interest" principle is predicated on the existence of a proprietary right which must be carried over into the reorganized corporation, the taxpayer at one and the same time asserts that a "continuity of interest" existed in the reorganized company, even though there was *no* proprietary interest by the stockholders in the merged corporation to be carried over into the reorganized corporation.

It is unnecessary, however, to further explore this contention because two things are so clear that he who runs may read. First, the stockholders in South Jersey had a definite and clearly fixed proprietary interest in its property. The lease provided that all replacements and additions to the leased property were to be the property of South Jersey and subject to the terms and conditions of the lease. Further, on the expiration of the lease all the property subject to its terms was to be returned to South Jersey. South Jersey owned the property under lease even though that lease was for a 900-year term. The lease further provided that upon default of its terms South Jersey could terminate the lease and *re-enter and re-acquire the property and additions and extensions thereto.*

In view of the incontrovertible facts the taxpayer's argument that the stockholders in South Jersey had *no* proprietary interest is without basis.

Finally, it is equally clear that when the stockholders of South Jersey exchanged their stock in that corporation for the long-term bonds of Public Service Electric and Gas Company, they surrendered their proprietary interest and simply became creditors of Public Service. They no longer owned any of the former property of South Jersey and they had no proprietary interest in the property of Public Service. The Tax Court succinctly described the situation when it stated:

> . . . *It follows that no continuing stake in the merged enterprise was retained by South Jersey or its stockholders, and hence that the requisite continuity of interest is not furnished either by the proprietary interests acquired by the merged corporation, nor by the bondholders' status conferred upon the former shareholders.* (emphasis supplied)

Taxpayer urges that the substance of the transaction here is close to that involved in Commissioner v. Neustadt's Trust et al., 2 Cir., 131 F.2d 528. That is

not so. In the *Neustadt's Trust* case the taxpayers merely exchanged their holdings of long-term debenture bonds for an equivalent face amount of short-term debenture bonds and both the Tax Court and the United States Circuit Court of Appeals for the Second Circuit ruled that the transaction was part of a "recapitalization" where no transfer of assets and no change of capital stock occurred.

For the reasons stated the decision of the Tax Court of the United States is affirmed.

NOTE

1. *Applications of Roebling.* The Court of Appeals for the Fifth Circuit expressed its approval of the *Roebling* case in Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332 (5th Cir.), cert. denied, 342 U.S. 860 (1951), but split on whether the necessary continuity of interest was present in the case before it. There the holders of 41 per cent of the stock of the merged corporation received a total of $230,300 in cash, and holders of the remaining 59 per cent received about 16 per cent of the common stock of the continuing corporation (worth about $5600) plus about $340,000 of its bonds (worth 90 per cent of par) and $17,800 in cash. The majority thought that the low value of the stock disqualified the transaction, while Chief Judge Hutcheson, dissenting, thought this ignored "the fundamental facts of corporate investment." He argued that the common stock conferred an interest in the corporation's future and an opportunity to participate in control that justified finding the requisite continuity of interest.

2. *Dissenting shareholders.* A Type A reorganization (statutory merger or consolidation) may be used in preference to a Type B acquisition (stock for voting stock) because the acquiring corporation anticipates difficulties in acquiring the 80 per cent of the acquired corporation's stock required by §368(a)(1)(B); and the state law provisions for paying off dissenters may suggest use of a Type A reorganization rather than a Type C transaction (assets for voting stock), or vice versa. In the *Southwest Natural Gas Co.* case, summarized in the preceding paragraph, many of the old shareholders elected to take cash rather than stock or securities in the transferee corporation. This practice was commented on in Miller v. Commissioner, 84 F.2d 415, 418-419 (6th Cir. 1936):

> We attach no importance to the fact that some of the stockholders in the transferring corporation acquired no interest in the transferee. This is certainly not a test by which the effectuation of a merger or consolidation is to be determined, for it will rarely result when reorganizations, even in their strict literal sense, are undertaken that all stockholders will approve. It is almost universal experience that some non-assenting stock must be acquired otherwise than through the mechanics of the consolidation plan.

In Reilly Oil Co. v. Commissioner, 189 F.2d 382 (5th Cir. 1951), a reorganization was held to qualify under §368(a)(1)(D) although 31 per cent of the transferor's shareholders elected to receive cash. The court said:

> We are aware of no authority or valid reason which would support the contention that all or substantially all of the transferor's stockholders must acquire an interest in the corporation before a non-taxable reorganization can be effected. [189 F.2d at 384.]

A minority of the Tax Court, 13 T.C. 919, 929 (1949), felt that all, or at least substantially all, of the transferor's stockholders must participate in the exchange. The minority's position was based upon a "textual analysis" of §112(g) of the 1939 Code; the statute has since been slightly changed, see §368(a)(1)(D), but apparently not with this problem in mind.

Textual analysis aside, does the continuity of interest doctrine require that no large body of stockholders be paid off in cash or bonds? If a substantial part of the old stockholders sell out, should the whole transaction be regarded as a sale instead of a reorganization? The Regulations contain this somewhat ambiguous statement:

> Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and . . . a continuity of interest therein

on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization. [Regs. §1.368-1(b).]

The problem is complicated by the fact that §368(a)(2)(B), enacted in 1954, specifically authorizes a limited amount of cash or other property to be used in a Type C reorganization. Should any inferences be drawn from this new provision about the use of cash and other property in other types of reorganizations?

In a Type B reorganization, the statute allows only voting stock to be employed to acquire the stock of another corporation. There is no direct way to compensate non-assenters in cash. Would it be possible for the acquiring corporation to acquire 80 per cent of the stock of the other corporation for voting stock, and to buy out the non-assenters subsequently; or for assenting stockholders of the corporation that is being acquired to buy out the non-assenters for cash, and then transfer the stock in exchange for voting stock of the acquiring corporation?

3. *Bonds and notes under §354(a)(2) of the 1954 Code.* If the shareholders in the *Roebling* case had received both bonds and stock of Public Service under the merger, and the continuity of interest doctrine was satisfied, §354(a)(2) and §356(a) would require the bonds to be treated as "boot." Would the shareholder's gain (if any) constitute capital gain or ordinary income? Why does §354(a)(2), enacted in 1954, deny or restrict non-recognition if securities are received but not surrendered?

4. *The status of creditors in corporate reorganizations.* The materials in this section focus primarily on the consequences of a corporate reorganization to the shareholders of the corporation whose assets or stock are transferred. Almost always, however, the corporation will have creditors. How are they affected by the reorganization? Do they recognize gain or loss if they surrender their claims and get in exchange stock or securities of the reorganized corporation or other claims against it?

At the outset it should be noted that the creditors will not necessarily participate in the reorganization exchange. Thus, in a Type B reorganization, where the acquiring corporation exchanges its voting stock for stock of the acquired corporation, the creditors of both corporations may simply ride through the reorganization, preserving intact their claims against their respective debtors. Similarly, in a Type C reorganization, where the acquiring corporation exchanges voting stock for substantially all the properties of another corporation, the latter's creditors do not necessarily participate in the reorganization. They may continue as creditors of the transferor corporation, the assets of which now consist of the acquiring corporation's stock.

Alternatively, the acquiring corporation may assume the transferor corporation's liabilities, or take the properties subject to those liabilities, still without any exchange by the creditors. Ordinarily this will not constitute "boot" to the transferee. §357. Nor will the creditors recognize gain or loss, since their claims have not been paid, retired, or exchanged. Moreover, §368(a)(1)(C) states explicitly that the requirement that the acquisition be solely for the acquiring corporation's voting stock in a Type C reorganization is not breached by its assuming liabilities or taking property subject to liabilities. Similarly, in both Type A and Type D reorganizations, the creditors of the old corporation need not participate in an exchange.

On the other hand, there frequently will be an exchange. The creditors may surrender bonds, debentures, or notes of one corporation and receive stock or securities of another corporation. In general, the exchange will qualify under §354. One difficulty that may arise, however, is that short-term notes (whether given up or received) may not qualify as "securities." See further page 725 supra. There may be other problems as well. If in conjunction with a Type B reorganization (stock for stock), the acquiring corporation issues bonds in exchange for bonds of the acquired corporation, will the transaction fall outside §368(a)(1)(B) on the ground that it is not "solely" for voting stock? If the stock-for-stock exchange qualifies, will the bondholders' exchange be "in pursuance of the plan of reorganization" under §354(a)(1)? If the transaction does not qualify as a reorganization, all parties to it will recognize gain or loss; if it is a reorganization, but the bondholders' exchange does not qualify under §354(a)(1), they (but not the stockholders) will recognize gain or loss. Similarly, in a Type C reorganization, if the acquiring corporation issues its own evidences of indebtedness to creditors of the transferor corporation, instead of merely assuming the liabilities, will the transaction lose its status as a reorganization? If not, will

the bondholders' exchange qualify under §354(a)(1)? See Stoddard v. Commissioner, 141 F.2d 76 (2d Cir. 1944).

5. *Reorganizations of insolvent or financially distressed corporations.* In Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942), the creditors of an insolvent corporation who received stock of a reorganized corporation were held to have a "continuing interest" because, under the full priority rule of bankruptcy proceedings, they had "effective command over the disposition of the property" of the old corporation.

In Neville Coke & Chemical Co. v. Commissioner, 148 F.2d 599 (3d Cir. 1945), it was held that noteholders of a reorganized corporation who exchanged their notes for debentures and common stock could not claim non-recognition of their gain under what is now §354. The court relied on the *Pinellas* case and on LeTulle v. Scofield as establishing that notes received on an exchange do not evidence a continuing interest in the enterprise and are not "securities." It then held that notes are equally deficient if given up in the exchange. The debtor was in financial difficulties at the time of the exchange, but the court was unwilling to find that the creditors already owned the entire equity, and in fact the old stockholders did participate in the exchange. If, however, the creditors of a distressed corporation in reorganization receive stock or securities evidencing a proprietary interest in the enterprise, is it not probable that the claims they gave up, whatever their form, already represented in economic reality a proprietary interest in the assets? For a forceful statement of this view, see Griswold, Securities and Continuity of Interest, 58 Harv. L. Rev. 705 (1945).

A number of special problems are encountered in the reorganization of financially distressed or insolvent corporations. See §§371-373; Eustice, Cancellation of Indebtedness and The Federal Income Tax: A Problem of Creeping Confusion, 14 Tax L. Rev. 225 (1959); Darrell, Creditors' Reorganizations and the Federal Income Tax, 57 Harv. L. Rev. 1009 (1944); Tarleau, Some Tax Considerations in Reorganizations of Insolvent Corporations, 8 N.Y.U. Inst. on Fed. Taxation 201 (1950).

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Advice has been requested whether the transaction described below qualifies as a reorganization under section 368(a)(1)(C) of the Internal Revenue Code of 1954.

M corporation and *N* corporation were respectively engaged in the manufacture of children's toys and in the distribution of steel and allied products. At some time in the past, *M* corporation sold a substantial part of its operating assets for cash and notes to a third party and more recently sold all but a small part of the remaining operating assets for cash, also to a third party. Thereafter, for valid business reasons, it acquired all of the property of *N* corporation solely in exchange for its voting stock. *N* corporation distributed the *M* stock received to its shareholders and then dissolved. *M* corporation used the assets resulting from the sale of its operating assets to expand the operations of the steel distributing business acquired from *N* corporation.

Section 368(a)(1)(C) of the Code states that the term "reorganization" means the acquisition by one corporation, in exchange solely for all or part of its voting stock, of substantially all the properties of another corporation.

Section 1.368-1(b) of the Income Tax Regulations specifies that a reorganization, to satisfy the requirements of the Code, must result in a continuity of the business enterprise under modified corporate form. This requirement will not be satisfied unless the surviving corporation is organized to engage in a business enterprise. See, for example, Standard Realization Company v. Commissioner, 10 T.C. 708 (1948), acquiescence, C.B. 1948-2, 3. However, the surviving corporation need not continue the activities conducted by its predecessors. See Donald L. Bentsen et al. v. Phinney, 199 Fed. Supp. 363 (1961; and Ernest F. Becher v Commissioner, 221 Fed. (2d) 252 (1955). . . .

Since *M* corporation engaged in the steel distribution business after the merger, the requirement that the reorganization result in a continuity of the business enterprise within the meaning of section 1.368-1(b) of the regulations was satisfied in the instant case, even though the toy business formerly conducted by *M* corporation was discontinued.

Accordingly, it is held that the acquisition by *M* corporation of all of the properties of *N* corporation solely in exchange for its voting stock constitutes a reorganization as defined in section 368(a)(1)(C) of the Code.

In view of these conclusions, reconsideration has been given to Revenue Ruling 56-330, C.B. 1956-2, 204, which held, in part, that the required continuity of the business enterprise was lacking where the successor corporation in a transaction otherwise qualifying as a reorganization engaged in a new business enterprise entirely different from that conducted by its predecessors. The conclusions reached in the instant case are equally applicable to the question involved in Revenue Ruling 56-330.

Accordingly, Revenue Ruling 56-330 is revoked.

NOTE

1. *Continuity of business enterprise.* The Regulations have long stated that a reorganization presupposes both "a continuity of interest" on the part of the owners and "a continuity of the business enterprise." Regs. §1.368-1(b). What are the meaning and function of the later phrase in the light of Rev. Rul. 63-29?

2. *Carryover of tax attributes.* If N corporation had earnings and profits, would they be acquired by M along with the assets? See §381(a)(2) and §381(c)(2)(A). Would an operating loss incurred by N in the steel distribution business be acquired by M? See §382(b)(1) and §382(b)(2). If M had incurred an operating loss in the toy business, could it be applied to profits realized by M in the steel distribution business? See Beckett v. Commissioner, 41 T.C. No. 41 (1963) (§382 not exclusive route to disallowance of operating loss carryovers); Libson Shops, Inc. v. Koehler, supra page 429.

3. *Reference.* Tarleau, Continuity of the Business Enterprise in Corporate Reorganizations and Other Corporate Readjustments, 60 Colum. L. Rev. 792 (1960).

REV. RUL. 57-212

1957-1 C.B. 114

Advice has been requested as to the status, under section 306 of the Internal Revenue Code of 1954, of amounts paid by a corporation to its shareholders under its sinking fund provisions in redemption of preferred shares previously issued pursuant to a nontaxable reorganization.

Pursuant to a merger agreement, corporation *B* was merged into corporation *C* under the nontaxable provisions of sections 368(a)(1)(A), 361(a) and 354(a) of the Code. Both corporations were large publicly owned corporations. Under the terms of the merger agreement, each share of corporation *B* common stock (the only class of stock outstanding) was converted into one share of first preferred stock, one-half share of second preferred stock, and three shares of common stock of corporation *C*.

Under the amended certificate of incorporation, as set out in the merger agreement, corporation *C* is required, so long as any of the shares of first preferred stock are outstanding, to set apart in each year on specified dates cash in amounts equal to three percent of the greatest aggregate par value of shares of first preferred stock outstanding at any time after the effective date of the merger. In lieu of cash, corporation *C* may set aside at the par value thereof shares of first preferred stock acquired by it, other than through the operation of the sinking

fund. Any cash set aside is to be applied to the purchase of shares of preferred stock at a price not exceeding their par value or in redemption of such shares at par value.

Each of the three classes of outstanding shares of corporation *C* is widely held and is listed and traded extensively on the New York Stock Exchange. Since the first preferred stock has been selling on the New York Stock Exchange at a price in excess of its par value, cash set aside in the sinking fund has not been applied to the purchase of any such shares in the open market, but has been applied to the redemption, by lot, of sufficient first preferred shares to satisfy the sinking fund requirements.

In Revenue Ruling 56-116, C.B. 1956-1, 164, it was held that preferred stock issued (together with common stock) by the surviving corporation in exchange for common stock of the merging corporation in connection with a nontaxable statutory merger was section 306 stock as defined in section 306(c)(1)(B) of the Code. However, in view of the exception provided by section 306(b)(4), since the stocks of the two corporations were widely held by the public, it was held that section 306(a)(1) shall not be applicable to the proceeds of the disposition of the preferred stock issued in the merger, unless such disposition is in anticipation of a redemption after the issuance of the stock. Therefore, the issue presented in the instant case is whether the exception provided by section 306(b)(4), which otherwise would appear to be applicable under the above-cited Revenue Ruling, is rendered inapplicable by the operation of the sinking fund provisions.

In view of the facts presented, the Internal Revenue Service holds that the distribution of the first preferred stock at the time of the merger and the subsequent redemption of portions thereof under the sinking fund provisions are not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax within the meaning of section 306(b)(4). Therefore, the provisions of section 306(a)(1) will not be applicable to the proceeds of a sale of such shares (whether or not in anticipation of a redemption through the operation of the sinking fund), and the provisions of section 306(a)(2) will not be applicable to amounts distributed by corporation *C* in redemption of such first preferred shares to meet the requirements of its sinking fund provisions.

NOTE

1. *Implications of Rev. Rul. 57-212.* Should preferred stock issued as described in Rev. Rul. 57-212 or in Rev. Rul. 56-116 be classified as "section 306 stock"? The appropriate portion of the definition is §306(c)(1)(B), which "taints" preferred stock received in a tax-free reorganization only if it is issued in exchange for "section 306 stock" (not applicable here) or if "the effect of the transaction was substantially the same as the receipt of a stock dividend." Regs. §1.306-3(d) states that the preferred stock is "tainted" if "cash received in lieu of such stock would have been treated as a dividend . . ." Would the shareholders of the merged corporation in these rulings have been subjected to dividend treatment if they had received cash for their stock? If they had received a combination of common stock and cash? See §356, supra page 702. Is there to be a distinction, in "tainting" the preferred stock received, between those shareholders of the merged corporation who realized gain (so that cash might have been taxed, under §356(a)(2), as a dividend) and those who realized a loss on the exchange?

In Rev. Rul. 60-1, 1960-1 C.B. 143, the Internal Revenue Service ruled that preferred stock issued in a merger to preferred shareholders of one of the merging corporation did not constitute "section 306 stock," even though some of the shareholders also owned a small part of the common stock of the reorganized corporation.

2. *Reference.* Note, Exclusion from Section 306 Treatment in Unifying Reorganizations, 76 Harv. L. Rev. 1627 (1963).

SECTION M. ELECTIONS UNDER SUBCHAPTER S

In 1954, the Senate Finance Committee recommended the enactment of "new provisions which for the first time will eliminate the effect of the Federal tax laws on the form of organization adopted by certain small businesses . . . by giving certain corporations the option to be taxed as partnerships and by allowing certain proprietorships and partnerships the option to be taxed as a corporation." S. Rept., p. 118. The option permitting proprietorships and partnerships to be taxed as corporations was enacted as Subchapter R (§1361) of the 1954 Code. The proposal to permit corporations to be taxed as partnerships was rejected in conference in 1954, but it was revived four years later, modified, and enacted as Subchapter S (§§1371-1377).

In striking contrast to Subchapter R, which has proved to be of limited interest to taxpayers (supra p. 612), Subchapter S has been extensively utilized. For the taxable year 1960-61, for example, Subchapter S elections were in force for 90,000 corporations (almost 8 per cent of all business corporations filing returns). The principal features of Subchapter S are:

1. *Eligibility.* Subchapter S is applicable only to a "small business corporation," defined by §1371(a) as a domestic corporation which does not have more than 10 shareholders (all of whom must be either individuals or estates) or more than one class of stock. Subject to a minor exception enacted in 1964, an electing corporation may not be a member of an affiliated group (as defined in §1504, relating to consolidated returns), and it may not have a non-resident alien as a shareholder.

2. *Election.* A "small business corporation" becomes an "electing small business corporation," so as to bring Subchapter S into play, by filing an election, which is valid only if all shareholders consent. Once made, the election is effective for the taxable year for which it is made and for all succeeding taxable years, unless it is terminated (a) by the failure of a new shareholder to consent to the election, (b) by revocation, with the consent of all shareholders, (c) by disqualification (e.g., acquisition of stock by a trust, corporation, or other ineligible shareholder, issuance of a second class of stock, etc.), (d) by the corporation's deriving more than 80 per cent of its gross receipts from sources outside the United States, or (e) by the corporation's deriving more than 20 per cent of its gross receipts from certain personal holding company sources.

Once an election has been terminated or revoked, the corporation (and any successor corporation) is ineligible to make another election under Subchapter S for five years, unless the Treasury consents.

3. *Undistributed corporate income.* While the election is in effect, the corporation is not subject to the corporate income tax, the accumulated earnings tax, or the personal holding company tax; and the corporate income, whether distributed or not, is taxed to the shareholders. Not having been subjected to a tax at the corporate level, however, the income is not eligible for the dividends received exclusion or credit in the hands of the shareholder. In the interest of simplicity, the income must be treated as ordinary income by the shareholder, without regard to any special characteristics it may have had at the corporate level, except that the excess of long-term capital gain over short-term capital loss is passed through to the shareholder. Since he is taxed on the corporation's undistributed income, provision is made for a later tax-free distribution to him of this previously taxed income.

4. *Corporate losses.* If a corporation suffers a net operating loss for a year during which the Subchapter S election is in effect, it is passed through to the

shareholders, each of whom may use his share of the loss (up to the aggregate basis of his investment in the corporation, in the form of stock or indebtedness) to offset his personal income from other sources. The balance, if any, may be carried back to prior years and forward to later years as though the loss had been incurred in his individual business.

5. *Adjustments to basis.* The shareholder's basis for his stock is increased to reflect the fact that he is taxed on his share of the corporation's undistributed income, and is decreased if this income is distributed to him. If the corporation suffers a net operating loss, the shareholder must reduce the basis of his stock (and, if necessary, any corporate obligations he may hold) to reflect the fact that the loss has been passed through to him for use on his individual tax return.

Despite the use of the term "small business corporation" in Subchapter S, the size of the corporation's income, assets, net worth, or other financial characteristics plays no part in determining its eligibility under Subchapter S; the only restriction of this type is that it may not have more than 10 shareholders. More important than labels, however, is the fact that an electing corporation remains a corporation — not only as a matter of state law, but also for many federal income tax purposes. This point cannot be over-emphasized, because it is often erroneously said that Subchapter S permits corporations to be treated as partnerships. In point of fact, there are many differences between a partnership and an "electing small business corporation." Even while the election is in effect, corporate redemptions, liquidations, reorganizations, and many other transactions are governed by the tax law applicable to corporations, rather than by the law of partnerships;* and if the election is terminated, the corporate income tax will once again become fully applicable. Recognizing these facts, some commentators have sought to sum them up in a label — "pseudo-corporation," "conduit-corporation," and "hybrid corporation," to say nothing of more barbarous coinages like "corpnership" and "pseudo-type corporation." The more neutral terms "electing corporation" or "Subchapter S corporation" seem preferable, because they serve as a constant reminder that the corporation does not cease to be a corporation by electing to come under Subchapter S.

A radical innovation like Subchapter S inevitably breeds a host of technical questions which will be answered only slowly by administrative rulings, litigation, and legislative amendments.† Although the tax bar, with its usual skill, patience, and intensity, has been dissecting Subchapter S since its enactment in 1958, the process of conjuring up problems and difficulties is still far from complete.

HAUPTMAN v. DIRECTOR OF INTERNAL REVENUE

309 F.2d 62 (2d Cir. 1962)

Before WATERMAN, KAUFMAN and MARSHALL, Circuit Judges.

WATERMAN, Circuit Judge.

Novo-Plas Mfg. Co., a New York corporation from 1946 through 1957, filed its corporate income tax returns on a calendar year basis. In 1955 and 1956 its returns disclosed taxable income in the approximate sum of $29,000, upon which it duly remitted taxes to the District Director of Internal Revenue. In 1957 the corporation suffered a net operating loss of $10,424.93. On May 6, 1958, one Raymond Zurawin became the sole shareholder of Novo-Plas Mfg. Co., Inc. The

* One of the attractions of Subchapter S, in fact, is that the shareholders may participate in pension and profit-sharing plans, etc., which are closed to individual proprietors and partners.

† The following is from an editorial note in 37 Taxes 20 (1959): "The evidence is mounting that the new Subchapter S . . . is a hasty pudding, with a number of errors in its drafting and providing some unintended benefits. However . . . it is a commendable piece of legislation [!]"

corporation allegedly incurred a net operating loss of $184,535.70 during 1958, and apparently did not pay all of its employment, social security, and withholding taxes.

On September 2, 1958, the Internal Revenue Code was amended to create Subchapter S, Sections 1371-1377; and any corporation that could qualify as a small business corporation under that subchapter was granted 90 days within which to elect to receive the tax treatment permissible under these amendments. Novo-Plas Mfg. Co., Inc., having but one stockholder, was eligible, and on November 29, 1958, elected to receive small business tax treatment under Subchapter S.

On January 23, 1959, Novo-Plas assigned its assets for the benefit of creditors, by an assignment duly filed under the New York State law. On February 16, 1959, an involuntary petition in bankruptcy was filed against the corporation, and on March 23, 1959, it was adjudged a bankrupt.

The petitioner-appellant herein is the trustee in bankruptcy. . . . On September 2, 1959, the trustee, by two separate refund claims filed with the Director, made claim for tax loss carry-back refund based on the bankrupt's above mentioned operating losses for 1957 and 1959. . . .

In the same year Raymond Zurawin and wife filed a claim for a refund of income taxes that they had paid, and asserted that the net operating loss of the corporation for the year 1958 was allowable to them personally rather than to the corporation because of the election the corporation made on November 29, 1958, under Section 1372(a) of the Internal Revenue Code. The trustee then moved the referee in bankruptcy for an order recognizing only the trustee, to the exclusion of the Zurawins, as the one entitled to utilize the bankrupt corporation's operating loss for the calendar years 1957 and 1958 as a basis for a tax refund of income taxes paid for the years 1955 and 1956, and to restrain the Zurawins from utilizing the operating losses as a basis for personal tax loss carry-back. . . .

The only issue before us is whether the trustee of the bankrupt corporation or the individual shareholder is entitled to the right to utilize the bankrupt corporation's 1958 operating loss as a basis for tax deductions by carrying back the net operating loss for that year and applying it against taxes paid for the years 1955 and 1956.

Section 1374 of the Internal Revenue Code, a part of Subchapter S, allows the shareholders of a corporation qualifying under that subchapter to deduct on personal income tax returns for the net operating loss incurred by the corporation. A related section, Section 172(h) of the Code, precludes the corporation from taking a net operating loss deduction when such deduction is taken by the shareholders of the corporation and used by them to reduce their respective personal income tax liabilities.

Reminding us that a court sitting in bankruptcy is a court of equity and relying heavily on Pepper v. Litton, 308 U.S. 295 (1939), the bankruptcy trustee in the present case asserts that it would be inequitable to permit the bankrupt's sole shareholder, instead of the bankrupt's creditors, to take advantage of the large tax deduction which is at issue here. In the *Pepper* case the Supreme Court held that a claim for unpaid salary filed by the sole shareholder of the bankrupt corporation there involved should be disallowed inasmuch as the claim was an unconscionable attempt to swallow up all of the corporate assets and thus avoid liability for a debt the corporation owed to a general creditor.

We are aware of the equitable nature of bankruptcy proceedings. See e.g., Pepper v. Litton, supra, at 304. . . . However, permitting the shareholder to avail himself of the net operating loss incurred by the bankrupt corporation here would not appear to be so unfair that equity requires us to determine this appeal in the trustee's favor. The trustee would have us hold that an otherwise qualify-

ing corporation may not elect Subchapter S tax treatment when the corporation is insolvent or when corporate bankruptcy is imminent. The language of the Code does not refer to such a limitation upon the shareholders' power to elect Subchapter S treatment. The so-called equitable considerations urged upon us by the trustee are substantially weakened by the fact that the present litigation is as much a squabble between two sets of creditors — the Government, a preferred creditor, on the one hand, and the remaining creditors on the other — as it is a dispute between the sole shareholder of the bankrupt corporation and the bankrupt's creditors.

The trustee contends that it is unjust to allow the shareholder of a one-man corporation to elect under Subchapter S and thereby personally receive the use of the deduction for the corporation's net operating loss at a time when liquidation of the corporation is foreseeable. In Section 1374, however, Congress invited shareholders of small business corporations to avail themselves of the tax advantage derived from using their corporation's net operating losses as deductions on their personal income tax returns. It is common knowledge that corporate operating losses often lead to corporate liquidation. Therefore, the likelihood that an otherwise qualifying corporation may be liquidated is not a factor that should be considered in order to justify a judicial restriction upon the right to elect the tax treatment Congress granted by Subchapter S. See Patty, Qualification and Disqualification Under Subchapter S, N.Y.U. 18th Inst. on Fed. Tax 661, 665 (1960).

Further valuable evidence of the statutory policy allowing an election even though liquidation is foreseeable is the Commissioner's refusal to make a pertinent proposed regulation a part of his final regulations. Proposed Treas. Reg. §1.1372-1(a)(2) provide in part:

> [A] corporation is not eligible to make an election under Sec. 1372(a) if it is in the process of complete or partial liquidation, if it has adopted a plan of such liquidation, or if it contemplates such liquidation or the adoption of a plan of such liquidation in the near future.

By not adopting this regulation the Commissioner would appear to have indicated his own belief that the policy behind Subchapter S permitted small business corporations to elect the benefits of the statute even though corporation liquidation was contemplated.

The trustee has a further argument in support of his position that it is unfair to the corporate creditors to permit the sole shareholder to use on his personal income tax return the corporation's net operating loss deduction. The trustee informs us that because of the limitation in §1374(c)(2) on the extent to which a shareholder may avail himself of his corporation's net operating loss, a large part of the net operating loss deduction here at issue will likely go unused, and an undeserved benefit will thereby be bestowed upon the Government. This contention is summarily answered by pointing out that tax benefits offered by the Code frequently turn out to be unavailable to taxpayers because of rather rigid statutory limitations Congress placed upon the right to receive those benefits.

The trustee has failed to show us a convincing reason why Section 1374 should not be interpreted in accordance with its obvious meaning.

NOTE

1. *Pass-through of business losses under Subchapter S.* Because §1374 provides that the net operating loss of a Subchapter S corporation is passed through to its shareholders, the election may be attractive to the shareholders of a corporation that anticipates a series

of loss years. (By virtue of §1374(c)(2), however, a shareholder may not deduct more than the adjusted basis of his investment in the corporation.) How would the taxpayer in the *Whipple* case (supra p. 285) have been affected if his corporation had made an election under Subchapter S?

2. *Subchapter S and partial liquidations.* Consider the possibility of using Subchapter S in these circumstances: XYZ, Inc., owns an apartment building with a fair market value of $150,000 and an adjusted basis of $50,000. The shareholders would like to arrange a sale of the building and a distribution of part of the proceeds, but they do not want to employ §337 because a complete liquidation of the corporation would entail recognizing capital gain on the distribution of its other assets. If they make a Subchapter S election for the year of the sale (intending to revoke it for the following year) and cause the corporation to sell the building and distribute $100,000 of the proceeds, what will the tax results be? What would have been the result if the same amount had been distributed without a Subchapter S election, or if the corporation had distributed the building to the shareholders and it had then been sold by them?

3. *Use of Subchapter S by collapsible corporations.* If the shareholders of a real estate corporation want to effect a sale of its property and a liquidation, but are fearful that it may be a collapsible corporation, can they sidestep §341 by electing under Subchapter S and having the corporation sell the property, distribute the profit to them, and liquidate subsequently? Recall that §337(c)(1)(A) prevents a collapsible corporation from making use of §337, so that the corporation's gain on a sale of the property would be taxable to it in the absence of a Subchapter S election. Note also that if the shareholders relied on §341(e) to escape the stigma of collapsibility (supra p. 688), their own business activities would be taken into account in determining whether the building was a "subsection (e) asset." If they employ Subchapter S, is the building's status as a capital asset to be determined solely by reference to the corporation's activities? See Regs. §1.1375-1(d).

4. *Other occasions for Subchapter S elections.* Although the central purpose of Subchapter S is to permit taxpayers to employ a corporation for its local law characteristics but to report its current income on a quasi-partnership basis, Subchapter S elections may also be used to obtain the federal tax advantages of the corporate form without paying the corporate income tax. Thus, a corporation may elect a taxable year different from its shareholders' year, whereas a partnership is forbidden by §706(b)(1) to adopt a taxable year different from that of its principal partners unless a business purpose for doing so can be established. Similarly, shareholders can become "employees" of their corporation for such tax purposes as qualified pension plans, excludable sick pay, etc., while partners cannot qualify as employees of their firm. An election under Subchapter S may also be appealing if the sole or principal shareholder is prepared to transfer some of his shares to members of his family by gift preparatory to routing a proportionate share of the corporation's income to them. Note, however, that §1375(c) imposes a limitation on using the Subchapter S corporation as an income-splitting device that is comparable to §704(e)'s restriction on the use of the family partnership.

5. *References.* Lourie, Subchapter S After Three Years of Operation, 18 Tax L. Rev. 99 (1962); Stein, Optional Taxation of Closely Held Corporations Under the Technical Amendments Act of 1958, 72 Harv. L. Rev. 710 (1959), continued in 3 Tax Counselor's Quarterly, 63 (1959); Anthoine, Federal Tax Legislation of 1958: The Corporate Election and Collapsible Amendment, 58 Colum. L. Rev. 1146, 1149-1175 (1958); Cohen, Relationship Between Provisions of Subchapter S and Subchapter C, 20 N.Y.U. Inst. on Fed. Taxation 827 (1962); Peden, Problems Resulting from the Death of the Principal Partner or Principal Shareholder of Subchapter S Corporation, 21 id. 1051 (1963); Note, "Locked-In Earnings" — How Serious a Problem Under Subchapter S? 49 Va. L. Rev. 1516 (1963); Moore and Sorlien, Adventures in Subchapter S and Section 1244, 14 Tax L. Rev. 453 (1959).

For evaluations of Subchapter S and legislative proposals, see articles by Caplin, Driscoll, Price, and Nicholson, 3 Tax Revision Compendium (House Ways and Means Committee, 1959) 1711-1748; Special Committee on Subchapters R and S, 16 Bulletin of A.B.A. Section of Taxation 276 (1963).

CHAPTER 8

Partners and Partnerships

Section 181-190 of the 1939 Code, relating to partners and partnerships, provided only a bare outline, which was filled in, if at all, only by case law and administrative practice.

The corresponding provisions of the 1954 Code, §§701-771, are far more detailed. They do not reject the spirit of pre-1954 law, and to some degree they codify old cases, but there are also many modifications. The relevant sections are referred to in the editor's notes hereafter.*

SECTION A. CURRENT PARTNERSHIP INCOME

SENATE REPORT NO. 1622

Senate Finance Committee, 83d Cong., 2d Sess. 376-378 (1954)

Section 702. Income and credits of partner

This section [of the 1954 Code] represents no change in current law and practice. . . .

[Section 702(a)] requires each partner, in computing his individual tax, to take into account separately his distributive share of certain items of income, deduction, credit, etc., of the partnership. For purposes of applying this subsection, a partner's distributive share of any item is to be computed in accordance with the provisions of section 704.

Paragraphs (1) through (7) of [§702(a)] specifically require conduit treatment with respect to several major items of income, deduction, etc. The first three of such paragraphs provided that each partner shall treat his distributive share of partnership short-term and long-term capital gains and losses, and gains and losses

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* See Willis and Bauman, Recent and Prospective Developments in Taxation of Partnerships, 16 Vand. L. Rev. 291 (1963):

"Subchapter K of the Internal Revenue Code of 1954 and the Regulations promulgated pursuant to it introduced substantial and radical changes into the codified tax laws applicable to partners and partnerships. The developments in this area, however, from that time until now have been relatively few in number and conservative in nature. Whether it be that the partnership area is one which, because of its complexity or otherwise, causes more tax planning and consultation before transactions are consummated, whether it be that the provisions of the Code have not had time to be applied prospectively in published rulings or retrospectively in litigation following audits, or whether it be simply that the partnership is an infrequently used or seldomly audited entity, the amount of authority is sparse. The activity in the area in terms of recent developments is meager."

For proposals to amend the still-pristine changes of 1954, see Advisory Group on Subchapter K, First Report (1957) and Supplementary Report (1958); Hearings, House Committee on Ways and Means, 86th Cong., 1st Sess. 974-1006 (February and March, 1959); Anderson and Coffee, Proposed Revision of Partner and Partnership Taxation: Analysis of the Report of the Advisory Group on Subchapter K, 15 Tax L. Rev. 285 and 497 (1960).

For a general survey of the 1954 provisions, see Jackson, The Internal Revenue Code of 1954: Partnerships, 54 Colum. L. Rev. 1183 (1954); McDonald, Income Taxation of Partnerships — A Critique, 44 Va. L. Rev. 903 (1958).

from sales or exchanges of property subject to the provisions of section 1231 (relating to certain property [used] in a trade or a business and involuntary conversions), as though realized by the partner separately. Such gains and losses accordingly are to be added to, or subtracted from, any items of similar character realized by the partner outside the partnership.

Under paragraph (4), each partner will treat as a charitable contribution by him his distributive share of charitable contributions made by the partnership. The partner's distributive share of such charitable contributions will be taken into account in applying, at the individual level, the limitation on charitable deductions.

Under paragraph (5), each partner is credited with his share of any dividends received by the partnership for purposes of determining his dividends received credit, the dividends received exclusion, or the dividends received deduction (in the case of a corporation which is a member of a partnership). A technical amendment by your committee to this provision of the House bill makes clear that only dividends which would qualify for the dividends received credit under section 34 or the dividends received deduction under part VIII of subchapter B are considered as received by the partners separately under this paragraph.

Under paragraph (6), taxes paid or accrued by the partnership to a foreign country or possession of the United States, and with respect to which the foreign tax credit may be claimed under section 901, are attributed to the partners individually, in accordance with their respective share of such taxes. Accordingly, each partner will add his distributive share of such taxes to any similar taxes paid or accrued by him individually. The partner then has the option to apply the total amount of such taxes as a deduction against income, or as a credit against tax, subject to the limitation on the foreign tax credit.

Paragraph (7) treats partially tax exempt interest on obligations of the United States or instrumentalities of the United States as though realized by each partner separately, in accordance with his distributive share of such income.

Paragraph (8) is a "catch-all" provision which authorizes the Secretary or his delegate to prescribe regulations to require each partner to take into account separately his distributive share of any other items of income, gain, loss, deduction, or credit, the character of which would affect the computation of the partner's personal income tax. For example, partnership gain or loss from gambling operations may be required to be segregated in order to permit individual partners to offset personal gambling gains and losses against their shares of such gains and losses realized by the partnership. Similarly, non-business income or loss may be required to be segregated for purposes of applying the net operating loss provisions to the partners separately.

Paragraph (9) provides that the total amount of taxable income or loss, exclusive of items required to be segregated by other provisions of this subsection, shall be attributed to each partner in accordance with his distributive share thereof. In general, the income or loss under paragraph (9) corresponds to the so-called "ordinary" partnership income or loss under the provisions of the 1939 Code.

[Section 702(b)] contains a "conduit" rule which makes clear that the character of any item realized by the partnership, and included in a partner's distributive share shall be the same as though he had realized such item directly, rather than through his membership in a partnership, from the source from which it was realized by the partnership and in the same manner.

[Section 702(c)] relates to the determination of a partner's share of the gross income of a partnership. It will be noted that section 61(a), which defines gross income, has been amended by your committee to make clear that a partner's gross income, includes his distributive share of a partnership gross income. How-

ever, under [§702(b)], the determination of a partner's share of the gross income of the partnership need not be made annually, but only where the determination of the partner's individual gross income is required for income tax purposes. For example, a partner is required to include his distributive share of partnership gross income in computing his individual gross income for the purpose of determining the necessity of filing a return. A partner's gross income may also be relevant for other tax purposes, such as . . . the amount of gross income received from possessions of the United States [§931], and the extended period of limitations applicable to deficiencies where there has been an omission of 25 per cent of gross income [§6501(e)].

Section 703. Partnership computations

[Section 703(a)] combines provisions of sections 183 and 189 of the 1939 Code, effecting no change in existing law. It states that the taxable income of a partnership, although not taxable as such, shall be computed in the same manner as the taxable income of an individual, with certain exceptions. The classes of items described in section 702(a) must be separately stated. In addition, certain deductions which are applicable only to individuals are not allowed in the computation of partnership income. These are the optional standard deduction, the deduction for personal exemptions, the net operating loss deduction, and the itemized deductions for individuals provided in part VII, such as the medical expense deduction.

The House provisions have been amended by your committee to make clear that partnerships shall not be entitled to deductions for taxes paid or accrued to foreign countries or possessions of the United States, or for charitable contributions, since such deductions are taken by the partners individually under section 702.

[Section 703(b)] requires that all elections (other than the election with respect to foreign taxes) affecting the computation of income derived from a partnership shall be made by the partnership. Thus, elections as to methods of accounting, methods of computing depreciation, the use of the installment sales provision, the option to expense intangible drilling and development costs, *etc.*, must be made by the partnership, and must be applicable to all partners equally. An exception is made permitting a separate election by each partner to use his distributive share of taxes paid or accrued by the partnership to foreign countries and possessions of the United States either as a credit or as a deduction. The exception as to foreign taxes does not constitute a change in existing law, although it eliminates a possible interpretation of sections 183 and 186 of the 1939 code which might permit both the credit to the partners and the deduction to the partnership.

NOTE

1. *The partner's "distributive share" of income.* Section 702(a) requires the partner to take into account, in determining his own income tax, "his distributive share" of the partnership's income. The 1939 Code explicitly provided, in §182, that this must be done "whether or not distribution is made" to the partner, and this was construed to require a partner to report his proper share of partnership income even though distribution was delayed by a dispute or litigation among the partners. Bell v. Commissioner, 219 F.2d 442 (5th Cir. 1955); Beck Chemical Equipment Corp. v. Commissioner, 27 T.C. 840, 854-856 (1957); for the effect of fraud, see Starr v. Commissioner, 267 F.2d 148 (7th Cir. 1959); Woods v. Commissioner, ¶58,134 P-H Memo T.C.

Having taken his share of the firm's income into account as it was earned, the partner is of course not required to report it a second time when it is distributed to him. The statutory framework insulating him from a second tax is §731(a)(1), under which no gain is recognized by the partner on a distribution unless the money distributed exceeds the

adjusted basis of his interest in the partnership — and his basis will have been previously increased under §705(a) by his distributive share of the partnership's income. Similarly, if the partner sells his interest in the firm rather than withdrawing his share of the income, his basis will reflect his share of the undistributed income and hence he will realize no gain pro tanto.

2. *Year-end changes in partners' shares.* Minkoff v. Commissioner, ¶56,269 P-H Memo T.C., concerned a partnership agreement providing for specific partnership interests but also for a division of profits at the end of the year "on a mutually agreeable basis." The division thus agreed upon was held binding for tax purposes, in the absence of some reason for disregarding it. See also Straight v. Commissioner, 221 F.2d 284 (8th Cir. 1955), where the agreement for a limited partnership provided for a stated rate of return for the limited partners, plus a larger percentage at the option of the general partners. The added amount was held taxable to the limited partners who received it, not to the general partners, in the absence of a showing that the arrangement was made to avoid taxes.

3. *Allocation of specific items by agreement.* Assume that A and B share equally in the profits of a partnership that in a given year realizes total income of $50,000, of which $5000 is tax-exempt interest on municipal bonds and $20,000 is long-term capital gain. May the tax-exempt interest and capital gain be allocated to A, a high bracket taxpayer, and the ordinary income to B, who is either in a low bracket or has offsetting losses on non-partnership transactions? See §704(b); Regs. §1.704-1(b); Cleveland v. Commissioner, 297 F.2d 169 (4th Cir. 1961) (deduction of §174 research expenditures by joint venturer).

4. *The partnership's taxable year.* See §706(a), re-enacting §188 of the 1939 Code. If two taxpayers on the calendar year basis form a partnership on February 1, 1964, and select February 1 through January 31 as the partnership's fiscal year, no partnership income will be reported in their individual returns until 1965, and there will be a similar lag between income and tax in later years, resulting in a postponement of tax that may be helpful to a new and expanding enterprise. But note that §706(b), which is new, prevents the partnership from adopting or changing to a taxable year different from that employed by its principal partners unless it establishes a business purpose for doing so, and imposes a correlative limitation on changes by the principal partners of their personal taxable years. See also §442, requiring Treasury consent to a change in the taxpayer's annual accounting period.

A disparity between the tax years of the partner and the partnership may be reflected in a disadvantage as well. To continue with the example just given, if the partnership's taxable year should close on December 31, 1965, as the consequence of a termination of the firm, the 1965 returns of the individual partners must include both the February 1, 1964, through January 31, 1965, income of the partnership and its February 1, 1965, through December 31, 1965, income, with a consequent pyramiding of tax. Guaranty Trust Co. v. Commissioner, 303 U.S. 493 (1938); see also Girard Trust Co. v. Commissioner, 182 F.2d 921 (3d Cir. 1950); Commissioner v. Waldman, 196 F.2d 83 (2d Cir. 1952). But this is less of a problem than it was before the 1954 Code was enacted, because §706(c) provides that the partnership's taxable year shall not close as a general rule in circumstances that before 1954 would often have produced a termination of the taxable year. Even before §706(c) was enacted, moreover, there was a growing tendency to allow the taxable year of the firm to continue despite the death or retirement of one partner. See Rev. Rul. 144, 1953-2 C.B. 212; Commissioner v. Tyree, 215 F.2d 78 (10th Cir. 1954).

5. *Electing "out" of partnership provisions.* Section 761(a) authorizes the Secretary by regulation to excuse certain unincorporated organizations from filing a partnership return. The Senate Report (p. 407) states: "In order for any organization to be so excluded, the members of such an organization must be able to determine their income without the necessity of computing a partnership taxable income." The provision seems primarily designed for co-owners holding real estate for investment and for certain oil ventures. See Regs. §1.761-1(a)(2).

See again §1361 (supra p. 612), permitting certain partnerships to elect to be taxed as corporations.

6. *References.* McDonald, Distributive Shares of Partnership Income and Loss, 15 N.Y.U. Inst. on Fed. Taxation 41 (1957); Sullivan, Conflicts Between State Partnership Laws and the Internal Revenue Code, 15 Tax L. Rev. 105 and 229 (1959 and 1960); Com-

ment. Allocation of Income, Gain and Loss in Partnership Taxation, 38 Tulane L. Rev. 104 (1963).

FALCONER v. COMMISSIONER

40 T.C. 1011 (1963)

[In 1957, the taxpayer entered into a partnership agreement with Stella Breazeale to operate an employment agency. Stella Breazeale contributed the entire capital of the firm ($19,775), and the agreement provided for a salary of $150 per week to the taxpayer for his services. During the years 1957-1958, he received payments totally $5400 for services. The firm was dissolved on May 12, 1958, having suffered an operating loss in 1958 of about $7300, and was succeeded by a corporation. At the time of the dissolution, taxpayer executed a demand promissory note payable to the order of Stella Breazeale in the amount of $9862.50.

[The taxpayer did not report the $5400 he received from the partnership on his 1957-1958 returns, and he deducted one half of the $7300 loss on his 1958 return.

[Among other provisions, the partnership agreement provided:

6.

As compensation for services to be rendered by the partners, each is to be paid as a salary the sum of $150.00 per week, such salaries to be paid on such date of the week as may be mutually agreed. The amount of compensation for each partner so agreed to is subject to change only by the mutual agreement of the partners. The salaries so paid insofar as the partners are concerned shall be considered as a part of the operating expense of the business.

7.

It is recognized by the partners that Breazeale has advanced certain sums of money to the partnership and may advance additional sums before the business has attained a sufficient volume of business and attained successful operation so as to pay the operating costs and expenses. It is agreed when the income of the business is sufficient to meet the cost of operations, any and all excess of such income shall be paid monthly to Breazeale until she has been repaid in full all of such advances.

The ownership of the partnership business shall be on the basis of 50% by Falconer and 50% by Breazeale, and after all advances referred to in the preceding paragraph have been paid to Breazeale, the share of the net profits shall be paid to Falconer as to 50% and paid to Breazeale as to 50%; the division of the net profits and the payment of the same to the respective partners shall be at such time or times as the partners may from time to time mutually agree. In the event of losses accruing to the partnership, each partner shall contribute his or her 50% portion of such loss or losses so that each partner shall bear his or her just portion of such loss and thus avoid the necessity of either partner having to suffer the entire loss. Neither partner shall draw from the business more than his or her respective portion of the net profits without the written consent of the other.

DAWSON, Judge: . . .

Issue 1. Guaranteed Payments.

It is the petitioner's contention that the payments, totalling $5,400, which he received from the partnership in 1957 and 1958 were loaned to him by his partner, Stella Breazeale, and, therefore, created a debt to her, as evidenced by the demand promissory note executed on the date the partnership was dissolved. Respondent, on the other hand, argues that the amounts received constitute guaranteed salary payments under the provisions of section 707(c). We agree with the respondent.

Section 707(c) has no counterpart in the Internal Revenue Code of 1939. It initially appeared in the Internal Revenue Code of 1954. Since we have been

unable to locate in our research any court decisions pertaining directly to the issue here presented, we approach the problem as one of first impression. But compare Foster v. United States, 221 F. Supp. 291 (S.D.N.Y. 1963). The legislative history of section 707(c) reveals that it was specifically intended to require ordinary income treatment to the partner receiving guaranteed salary payments and to give a deduction at the partnership level.[1]

The touchstone for determining "guaranteed payments" is whether they are payable without regard to partnership income. And, in determining whether in a particular case an amount paid by a partnership to a partner is a "drawing" or a "guaranteed payment," the substance of the transaction, rather than its form, must govern. See section 1.707-1(a), Income Tax Regs. These are both factual matters to be judged from all the circumstances.

We are convinced that the facts of this case clearly place the payments made to petitioner within the ambit of the term "guaranteed payments" as used in section 707(c). Paragraph 6 of the partnership agreement provided that each partner was to receive a salary of $150 per week from the partnership as compensation for services rendered; that the amount of the *compensation* agreed to was subject to change only by mutual agreement of the partners; and that such *salaries* were to be considered a part of the operating expenses of the business. In addition, paragraph 9 of the partnership agreement provided that, if a partner should be disabled for more than six months, the *compensation* provided for in paragraph 6 would not be paid to the disabled partner after such six month period expired. There is no doubt in our minds that these weekly salary payments were made "without regard to the income of the partnership." The partnership was being operated at a loss and, consequently, it was necessary to make the guaranteed salary payments out of the capital Stella Breazeale had contributed. Petitioner's mere characterization of the payments in the partnership returns as "withdrawals" is not persuasive when viewed in connection with the precise provisions of the partnership agreement. This leads us inescapably to the conclusion that the amounts received by petitioner from the partnership under the terms of the agreement are guaranteed payments without regard to the income of the partnership and, as such, are includible in his gross income.

Under the provisions of section 706(a) such payments are characterized as ordinary income to the recipient for his taxable year within or with which ends the partnership taxable year in which the partnership deducted the payments. Hence, the taxable year of the partnership must be first determined.

In view of these rules and the facts herein, this partnership could only adopt a calendar year basis. Since the petitioner reported his income on a calendar year basis during 1957 and 1958, and was a principal partner by virtue of owning a 50 percent interest in the partnership, the partnership was precluded from adopting a fiscal year basis without the prior approval of the Secretary of the Treasury or his delegate. The record not only fails to reveal such approval, but there is no evidence that such approval was ever sought. Thus, the only recourse remaining to the partnership was the adoption of a calendar year which under the specific

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[1] S. Rept. No. 1622 to accompany H.R. 8300, 83d Cong., 2d Sess., p. 387 (1954), contains the following explanation:

"Subsection (c) provides a rule with respect to guaranteed payments to members of a partnership. A partner who renders services to the partnership for a fixed salary, payable without regard to partnership income, shall be treated, to the extent of such amount, as one who is not a partner, and the partnership shall be allowed a deduction for a business expense. The amount of such payment shall be included in the partner's gross income, and shall not be considered a distributive share of partnership income or gain. A partner who is guaranteed a minimum annual amount for his services shall be treated as receiving a fixed payment in that amount."

language of section 1.706-1(b)(1)(ii), Income Tax Regs., does not require the prior approval of the Commissioner. See Austin Clapp, 36 T.C. 905 (1961), where we construed the provisions of section 706(b)(1) and the regulations with respect thereto. It then follows that the payments, totaling $2,550, made to petitioner during the partnership's taxable year ending December 31, 1957, were includible in his taxable income for the calendar year 1957. Since the partnership's existence terminated upon its dissolution on May 12, 1958, the partnership taxable year was closed on that date. As a result thereof, the guaranteed payments of $2,850 made by the partnership during the taxable year beginning January 1, 1958 and ending May 12, 1958, were includible in petitioner's taxable income for the calendar year 1958.

Petitioner stresses that the "withdrawals by F. A. Falconer, constituted a loan to him and not income." We find no merit in this position. His attempt to cast the relationship between himself and Stella Breazeale as that of debtor and creditor is wholly inconsistent with the express terms of the partnership agreement and contrary to all outward manifestations of their intent. Nor are we swayed by the fact that the petitioner executed a demand note for $9,862.50 to Stella Breazeale on the day the partnership was terminated. We do not even know for what purpose the note was given. The petitioner, who has the burden of proof, offered no evidence regarding it. Consequently, any conclusions we might try to draw with respect to the note and the purpose for it would be purely speculative. Even if we assume, as petitioner would have us do, that the note represented the "withdrawals" by the petitioner from the partnership and "his part of the expenses" paid from the capital account, it cannot serve to convert what was paid as salaries into something else. Certainly the character of such payments cannot be changed retroactively into a loan. . . .

Issue 3. Net Operating Loss.

. . . .

From the inception of the partnership through its dissolution, the petitioner made no contributions to capital. By the provisions of section 704(d), a partner may deduct currently his portion of distributable losses only to the extent of the adjusted basis of his interest in the partnership. Stated differently, a partner in any accounting year may deduct all of his portion of partnership loss *only* if he has sufficient "capital" retained in the partnership. Thus a determination of the basis of petitioner's partnership interest becomes necessary. Section 705 sets forth the basis of a partner's interest. Insofar as pertinent here, section 705-(a)(2)(A) provides that the adjusted basis of a partner's interest in a partnership shall be the basis of such interest determined under section 722 decreased (but not below zero) by the sum of his distributive share for the taxable years and prior taxable years of losses of the partnership. Since petitioner contributed neither money nor property to the partnership, the basis of his interest was zero. As previously noted, the petitioner's distributive share of the partnership loss is limited by section 704(d) to his adjusted basis, which was also zero, in determining the amount allowable as a deduction under section 702(a)(9). Accordingly, we conclude that none of the loss of the partnership is deductible by petitioner in either 1957 or 1958. . . .

NOTE

1. *"Guaranteed payments" to a partner.* Section 707(c) provides that "guaranteed payments" (payments to a partner for services or the use of capital, determined without regard to the partnership's income) shall be treated as payments to a non-partner, but only for

purposes of §61(a) and §162(a). What is the function of this provision? See Regs. §1.707-1, especially Example (3).

Because a guaranteed payment is not treated as a distribution of the partner's share of the firm's income, it does not operate as a "pass-through" of capital gains, tax-exempt interest, etc.

The Internal Revenue Service has ruled that a "guaranteed payment" received by a partner who is absent from work because of sickness does not qualify for the exclusion of §105(d) (relating to wage continuation payments): "Section 707(c) . . . does not have the effect of converting a partnership relationship into an employee relationship for the purpose of section 105(d) of the Code." Rev. Rul. 56-326, 1956-2 C.B. 100; Regs. §1.707-1(c). O'Brien's Estate v. Commissioner, ¶62,169 P-H Memo T.C., although holding against the taxpayer on the facts, seems to accept the theory that a guaranteed payment to a partner might meet the standards of §105(d). Other points at which the theory of the Regulations that the recipient of a guaranteed payment is not an "employee" would be relevant are: §101(b) (relating to employee death benefits); §119 (meals and lodging for convenience of employer); and §401 (qualified pension and profit-sharing plans for employees).

2. *Transactions between partner and partnership.* Section 707(a) provides for transactions between a partnership and a partner "other than in his capacity as a member of such partnership." In general, such transactions as the sale or rental of property by the partner to his firm, or vice versa, are treated as arm's-length business transactions in computing gain or loss, depreciation, etc. Note, however, the exceptions of §707(b).

3. *Ceiling on deductibility of partnership loss.* In the *Falconer* case, the court held that the taxpayer could not deduct his share of the partnership loss because the adjusted basis of his partnership interest was zero, relying on §704(d). Since he was liable under paragraph 7 of the partnership agreement for 50 per cent of the losses, and since §752(a) provides for an upward adjustment of a partner's basis to reflect any increase in his share of the firm's liabilities, why was his basis not at least as large as the loss he sought to deduct?

Will the taxpayer in *Falconer* ever be entitled to deduct the disallowed loss? See the second sentence of §704(d), relating to payments "to the partnership," and note that he executed a note to his co-partner when the firm was liquidated.

4. *Reference.* Crampton, Partner-Partnership Transactions, 15 N.Y.U. Inst. on Fed. Taxation 71 (1957).

SECTION B. CONTRIBUTED PROPERTY

HELVERING v. WALBRIDGE
70 F.2d 683 (2d Cir. 1934)

Before L. HAND, SWAN, and CHASE, Circuit Judges.

L. HAND, Circuit Judge.

This is a petition of the Commissioner of Internal Revenue to review an order of the Board of Tax Appeals which reduced a deficiency in the respondent's income tax for the year 1928. The taxpayer, Walbridge, with three others, formed a partnership to trade in financial securities; he and two other partners contributed shares of stock, and the fourth gave cash. The firm sold some of the shares contributed by Walbridge at a price higher than that at which he had bought them, and higher than their value when he contributed them.* In its income tax return the firm charged itself with the difference between the sale price of the shares and the cost at which it had accepted them, and concededly Walbridge was liable for an income upon his proportion of that profit. But the Commissioner further charged his income with the difference between the price at which the shares had been taken by the firm and their cost to him; and it is the tax on this

* The partnership was formed on November 30, 1928. On this date the securities, which had cost the taxpayer $114,360, were worth $237,297. They were sold by the partnership for $260,104. — ED.

gain that is now at issue. Walbridge maintains that he is not taxable upon it until the firm is dissolved, at which time it will come in as a profit or loss, according as his liquidating dividend is greater or less than the original cost of the shares to him. The Board so held and the Commissioner appealed.

Under the Act of 1928, as earlier, partnerships were obliged to make returns, and their income was computed as that of an individual, but the tax was imposed upon the partners, the firm itself not being taxable. Ever since the Act of 1918 the Regulations had provided that only upon dissolution of the firm did the partner individually "realize" any gain or loss on firm transactions, and at that time his gain was the difference between his liquidating dividend and the original cost to him of his contribution. . . . Indeed if the liquidating dividend was in kind, no gain was "realized" until the property distributed was sold, a provision of doubtful validity except perhaps in cases where the dividend did not itself have any "fair market value." In the face of such long continued departmental interpretation we should be slow to construe the statute otherwise; indeed we would not do so at all unless the statute flatly required it. It does not. The relevant section is [§1001(b)], which provides that "the amount realized . . . shall be the sum of any money received plus the fair market value of the property . . . received"; the critical words are "fair market value." The section has stood in substantially this form since 1918, with the exception of the Act of 1921, §202(c), 42 Stat. 230, where it read, "readily realizable market value"; a more comprehensive formula, for one may at times "readily realize" on goods which have no true market, "fair" or "unfair." [Regs. §1.001-1(a)] in implementation of this section declares that although "fair market value" is a question of fact, "only in rare and extraordinary cases does property have no fair market value." . . . The gloss we have quoted we cannot accept; "fair market value" is not nearly so universal a phenomenon as to justify such a comment, and the implication is misleading. Perhaps there need not be a "market" to establish a "market value," but there must be some assurance that the value is what a "market" would establish; and a "market" itself presupposes enough competition between buyers and sellers to prevent the exigencies of an individual from being exploited. It may well imply that the goods have several possible buyers, so that a necessitous seller shall not be confined to one; and that there are several possible sellers of the same goods or their substantial equivalent, so that a hard-pressed buyer shall not have to accept the first offer. . . . In the case at bar Walbridge's share in this firm, engaged in marketing securities, was not "marketable"; the assumption is wholly unfounded that it was worth the value of his contribution. Under the Partnership Law of New York §53, a sale of a partner's interest no longer disrupts the firm; it does not transfer any interest in the firm assets, but only the assignee's [assignor's?] rights upon an accounting and during the continuance of the firm. That goes along for its prescribed term and the eventual liquidating dividend cannot possibly be learned in advance. The decisions have so far attempted no definition of the phrase, proceeding rather by exclusion; we agree that it does not require a price determined in a conventional market like a stock or produce exchange; there are other "market" prices, recognized and accepted as such in trade. But all the cases have required some more palpable measure than any available here, which can be no more than an opinion as to the value of a unique right of action for which there were no known buyers, nor any but an imaginary demand. . . . So far therefore as the Commissioner proceeded on the theory that the value of Walbridge's shares in the firm could be made the minuend in an equation determining a "recognizable gain," he was wrong.

The Commissioner's second argument treats the partnership pluralistically, as the common law did before equity intervened. His theory is that when a firm sells

property contributed by a partner, it is a sale of the partner's property, and the gain may properly be divided into two parts; that which accrued before the contribution, and which can be taxed against him, and that arising thereafter, which must be taxed against the firm. Such a view ignores even the bare common-law outlines of a partnership — joint ownership and joint obligation — to say nothing of the scaffolding reared by equity to support the concept of the firm as an entity. By his transfer the partner ceases to be sole owner of what he contributes and thereafter holds jointly; his consideration is his own share in the contributions of the other partners. When the firm sells the entire interest in the contributed property the contributing partner sells only his reserved proportion, and the other partners sell their acquired proportions. If we kept very literally to the common-law view, we might say that the partner had "realized" a "gain" based upon the difference between his proportion of the selling price and the same proportion of his original cost, but that is as far as we could go. The other partners would have "realized" the difference between their proportion of the selling price and the same proportion of their cost, whatever that was; conceivably it might be either the original cost of the property to the contributing partner, in analogy with the rule as to gifts, or its value at the time of contribution. But in neither case could that gain be assessed against the partner who contributed the property, for he had no interest whatever in this part of the profit. He had altogether parted with the property except that proportion which he retained as partner; he had got for it his interest in the contribution of the other partners, and any gain to him must be measured in terms of that exchange. Moreover, he may not be taxed even upon the profit realized on that proportion of the property of which at common-law he remained owner. It was firm assets, he could not withdraw it; he had no effective power over it, and therefore no interest in it, save as it might figure in "his share of the profits and surplus." Section 52, N.Y. Partnership Law. It is true that the common-law even after equity was through, had not conceived the firm as a juristic person. . . . But for practical purposes the distribution was not very different and the legal interest of a partner as joint owner has long since lost most of its legal incidents. United States v. Kauffman, 267 U.S. 408. Thus it appears to us that the regulation provided the proper way to deal with a partner's rights, and that a necessary corollary from it is that no gain is "realized" by a separate partner when the firm sells partnership property.

Order affirmed.

NOTE

1. *Basis of contributed property:* §723. See also Archbald v. Commissioner, 27 B.T.A. 837 (1933), aff'd per curiam, 70 F.2d 720 (2d Cir. 1934).

In thinking through the implications of the *Walbridge* case, of a statutory change that the decision in the Board of Tax Appeals helped to bring on, and of the next case, the following illustration may be helpful: A and B each own an item of non-depreciable property with an adjusted basis of $25,000 and a present value of $35,000. They decide to pool their resources in an equal partnership, so its assets are worth $70,000. The assets are sold for that amount by the partnership and the proceeds are invested by the firm in other property costing $70,000. Thereafter these assets are distributed to A and B in liquidation of the firm; at the time of liquidation, the distributed assets are still worth $70,000, so A and B each get property worth $35,000. Then A sells his property for $35,000 and B does the same. It is clear enough that a total of $20,000 of taxable gain ought to be reported by A and B at some stage in the described proceedings. But when?

One might argue for the earliest date, when the partnership is formed. This is when the profit would be taxed if there were a transfer to a corporation, were it not for §351, and it could be argued by a parity of reasoning that A and B have each sold or exchanged

property for an interest in the partnership. Each would then have gain in the amount of $10,000, the difference between the basis of the property given up and the value of what was received in exchange. A variation on this approach would treat the transfer by A as a sale or exchange of a one-half interest in his property for a one-half interest in B's, and vice versa. Then, unless the transactions were viewed as a transfer of property for other property of a like kind under §1031, A and B would each recognize $5000 of income. That is, one half of A's property, with an allocated basis of $12,500, would be regarded as sold or exchanged for one half of B's property, with a value of $17,500, and vice versa. The rest of A's and B's income would be taxed at a later time, when the property is sold by the firm, when the firm liquidates, or when the assets received in liquidation are sold by A and B. But the *Walbridge* case refuses to view the transfer of appreciated property to a partnership as a taxable occasion, and its conclusion has met with general acceptance. See §721, codifying pre-1954 case law.

Under a second approach, it might be argued that when the property was sold by the partnership for $70,000, A and B each realized and should recognize his own $10,000 gain. This theory too was rejected by the *Walbridge* case, but here its conclusion has not been accepted. In fact, a few days before the case was decided by the Court of Appeals (but with the Board of Tax Appeals' decision in mind), Congress had already enacted what is now §723, providing that the partnership's basis for contributed property is the same as the transferor's basis.

Why did Congress reject this part of the *Walbridge* case? Not because the *Walbridge* case meant that the pre-contribution gain of A and B would go forever unrecognized; it would be quite consistent with the *Walbridge* case for the gain to be recognized (to return to the facts of the example above) either when the reinvested proceeds of the sale were distributed in kind to A and B or when the assets thus distributed were sold by them. A clue to the legislative rejection of the *Walbridge* rule may be found in Chisholm v. Commissioner, 79 F.2d 14 (2d Cir. 1935). Although this case was decided after §113(a)(13) of the 1939 Code (§723 of the 1954 Code) was enacted, it illustrates a tax technique about which Congress was concerned. Two individuals each owned 300 shares of corporate stock with a cost basis of $8000, but a total market value of almost $1,000,000. In contemplation of a sale, they transferred the shares to a partnership, which promptly sold the shares and retained and reinvested the proceeds. Under the *Walbridge* case, the partners did not realize gain either when the firm was formed or when it sold the stock (except to the extent that the property increased in value from the date it was contributed to the date it was sold). An attempt by the Commissioner to attack the transaction along *Gregory* lines failed, the court finding that "the purpose was certainly to form an enduring firm which should continue to hold the joint principal and to invest and reinvest it." * 79 F.2d at 15. While gain would be recognized by the partners either when they liquidated the partnership or at the latest when they sold the proceeds received on the liquidation, those dates could be selected at their option. Moreover, death might intervene and provide a stepped-up basis under §1014. Section 723, of course, alters this result by providing that the partnership's basis for the assets is the same as the individuals'.

When §723 was enacted in 1934, Congress sought to have its rule applied to past transactions, through an announcement in the committee reports that the section was declaratory of existing law, but as the *Walbridge, Archbald,* and *Chisholm* cases indicate, this proved to be mere whistling in the dark. H.R. Rept. No. 704, 73 Cong., 2d Sess., reprinted in 1939-1 C.B. (Part 2) 554, 567-568; S. Rept. No. 558, id. 586, 600-601.

2. *Allocation of income and deductions attributable to contributed property: §704(c).* Although §723 saddles the partnership with the partner's basis for contributed property, it does not prescribe a method for allocating the income thus computed among the partners. To vary the illustration above in order to present the problem, assume that A con-

* In distinguishing the *Gregory* case, the court said: "In Gregory v. Helvering . . . , the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world." 79 F.2d at 15.

tributes securities worth $35,000 but having a basis of $25,000, while B contributes $35,000 in cash. If the partnership should sell the securities for $35,000, there will be a gain of $10,000 as a result of §723. How is it to be allocated between A and B?

Before turning to §704(c), which for the first time provides a statutory guide to this area, we might consider several possible ways of dividing the gain. In the absence of a provision in the partnership agreement, there are three principal methods that might be adopted:

(a) The sale by the partnership could be regarded as a realization by A of the pre-contribution gain, and the entire $10,000 of income would then be taxed to him alone.

(b) The gain could be reported equally by A and B, if that is how post-contribution gains are shared. The basis of both A's and B's partnership interest would be increased by $5000, the amount of income taxed to each though not withdrawn. With this adjustment, A's partnership interest would have a basis of $30,000 and B's $40,000. On ultimate liquidation or sale of his interest, A would have a gain of $5000 (thus reporting in two steps his pre-contribution appreciation of $10,000), while B would have a loss of $5000, to offset the $5000 of taxable income previously reported by him when he had enjoyed no economic gain.

(c) At the time the partnership was formed, A's basis of $25,000 and B's basis of $35,000 could be redistributed between them, so that each would take a basis of $30,000 for his interest. On the sale of the securities, the $10,000 gain would be taxed to them equally, and the basis of the partnership interest of each would be increased from $30,000 to $35,000 in recognition of the taxed but retained income. There would then be no further tax to either A or B on the final liquidation or sale of his investment in the partnership or its property. A would ultimately be taxed on only $5000 though he had enjoyed $10,000 of gain, while B would be taxed on $5000 of gain he did not enjoy. These disparities would have certain compensations in simplicity of administration.

A choice among these methods for handling the gain or loss on contributed property that has a basis different from its value at the time of contribution is complicated by the fact that the property may be depreciable. Assume that A contributes depreciable property having an adjusted basis of $25,000 but a value of $35,000 and that B contributes $35,000 in cash. The partnership's basis for depreciation under §§167(f), 1011, and 723 is $25,000. Over the life of the asset, A and B together will be entitled to a total of $25,000 in depreciation deductions. But how should these deductions be allocated between them, assuming the partnership agreement is silent? Three methods, which correspond to the three methods described above for allocating the gain or loss on pre-contribution appreciation, may be noted:

(1) One method would be to allow A to take $7500 of the total depreciation deductions, while allocating $17,500 to B. To see how this method would work out, assume that after the property contributed by A has been fully depreciated, the firm has left only the $35,000 contributed by B and that no other transactions need be accounted for. Since A and B have equal interests in the firm's remaining assets of $35,000, A's interest cost him $25,000 for tax purposes (his adjusted basis for the contributed property) and is now worth $17,500, while B contributed $35,000 and now also has a partnership interest worth $17,500. The depreciation deductions of $7500 allowed to A under this method and $17,500 allowed to B will properly compensate them both for their losses. The basis of A's interest in the partnership would be $17,500 ($25,000 contributed, $7500 deducted) and B's basis would also be $17,500 ($35,000 contributed, $17,500 deducted), and no further gain or loss would be recognized on sales by them of their interests.

(2) A second method would allocate the total of $25,000 in depreciation deductions equally between A and B, allowing each to adjust the basis for his partnership interest to correspond, i.e., A would reduce his basis from $25,000 to $12,500 while B would reduce his basis from $35,000 to $22,500. Now if A sells his partnership interest (worth $17,500), he will recognize $5000 of gain. His actual loss of $7500 over the life of the firm (i.e., $25,000 of basis for the contributed property less $17,500 received on the sale) is reflected for tax purposes by $12,500 of depreciation deductions and $5000 of gain on the sale. B would recognize a loss of $5000 on selling his partnership interest. Thus his actual loss of $17,500 ($35,000 contributed; $17,500 received on the sale) would be recognized

for tax purposes in the form of $12,500 in depreciation deductions and $5000 of loss on the sale.

(3) A third method would start with an adjustment of the basis of the partnership interests at the time the property is contributed. This adjustment, described in (c) above, would give A and B a basis of $30,000 each for their respective partnership interests. The depreciation deductions would then be allocated equally between A and B, and the basis of each partnership interest would be reduced by $12,500 to $17,500. There would then be neither gain nor loss on sales by them of their partnership interests. The net result would be a loss by A of $7500 (i.e., adjusted basis of contributed property was $25,000; amount received on sale was $17,500) but tax deductions of $12,500. B would have suffered an economic loss of $17,500 but would have deductions of only $12,500. The aggregate of deductions ($25,000) would correspond with the aggregate losses ($25,000), but the allocation between A and B would be unfair. Just as this method produces an inaccurate allocation of gain if the property is sold, so it produces an inaccurate allocation of depreciation; but for both purposes it is easier of application.

Of these methods, the first was adopted by the Internal Revenue Service in G.C.M. 10092, XI-1 C.B. 114 (1932). This ruling was revoked in 1950 by G.C.M. 26379, 1950-1 C.B. 58, but the Service did not then endorse another method. The American Law Institute Draft of a revised Internal Revenue Code recommended adoption of the third method, with provision for an election to employ either of the other two. See Jackson, Johnson, Surrey, and Warren, A Proposed Revision of the Federal Income Tax Treatment of Partnerships and Partners — American Law Institute Draft, 9 Tax L. Rev. 109, 119-133 (1954); Little, Federal Income Taxation of Partnerships 112-123 (1952).

The 1954 Code provides, in §704(c)(1), for use of the second method as a general rule. But §704(c)(2) permits the partnership agreement to provide for a different allocation "so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." The Senate Report (pp. 381-382) uses the first method as an illustration of a permissible method under §704(c)(2). It is not clear whether the third method would be permissible; it requires a determination of the partners' bases for their interests in the firm at variance with that prescribed by §§705 and 722; but see §705(b) and S. Rept. 384.

See also §704(c)(3), relating to undivided interests in contributed property, which permits the contributed property to be segregated from the rest of the partnership property, with gain, loss, depreciation, etc. treated as though it were still owned by the individual partners. See Examples, Regs. §1.704-1(c)(3).

3. *Reference.* Gelband, Allocations of Income and Deductions Among Partners, 21 N.Y.U. Inst. on Fed. Taxation 997, 1003-1013 (1963).

SECTION C. SALES OF PARTNERSHIP INTERESTS

UNITED STATES v. WOOLSEY

326 F.2d 287 (5th Cir. 1963)

Before HUTCHESON and GEWIN, Circuit Judges, and HOOPER, District Judge.

GEWIN, Circuit Judge:

This case involves Federal income taxes for the years 1955 through 1959. The Government has appealed from a final judgment of the U.S. District Court for the Southern District of Texas in favor of the taxpayers. The question presented is whether the amounts received by the taxpayers in consideration for the sale of their rights and interests in their partnership business which owned a management contract with a mutual insurance company are taxable as ordinary income or as a long term capital gain. The sale involved a total consideration of $171,500.00. Many of the facts were stipulated and other facts were developed by testimony. There is no dispute as to the facts found by the trial court.

The taxpayers, R. T. Woolsey and V. G. Woolsey, were engaged in the management of mutual insurance companies for over 25 years. The management contract here involved existed between the taxpayers and Gulf Security Life Insurance Company, a mutual company. The taxpayers contend that the total consideration involved should be taxed as a long term capital gain, and the trial court so held. The management activities of the taxpayers were conducted as a partnership, also called Gulf Security Life Insurance Co., in which each of the brothers owned a 50% interest.

By the terms of the contract, 40% of all premiums were paid into a fund designated the "general fund," and delivered to the taxpayers. From this fund the taxpayers were required to pay all of the operating expenses of the company and any balance remaining was retained as a fee or compensation for managerial services. The management contract under consideration was executed on July 6, 1949, and was to continue for a period of 25 years. It provided that all office furniture, equipment, fixtures and all of the operating records of the company were to remain the property of the taxpayers and payment for these items was made by the taxpayers out of the 40% mentioned above. . . . For a number of years prior to 1955 the partnership filed Federal partnership returns showing income from the "management contract," and deductions for operative expenses of the insurance company together with deductions for depreciation attributable to the physical assets used in the operation and for amortization for the cost of the state-wide charter. The partnership return filed for 1954 was examined by Internal Revenue Service and accepted without change. The partnership owned no right to any renewal commissions on any insurance, but both of the brothers owned rights to renewal commissions for insurance written by them individually. Such rights to renewal commissions were not sold.

All negotiations and the sale involved the management contract, all the physical assets used in connection with management, the state-wide charter, and the operating records owned by the partnership together with all good will. The sale was consummated on August 15, 1955. In their respective returns for the year 1955, the taxpayers reported their gain from the sale on an installment basis as authorized by §453 of the I.R.C. of 1954, a pro rata portion of such gain having been reported in the years 1955 through 1959. Profits were treated as long term capital gains. The contract between the Woolseys and Gulf Security Life Insurance Company was to continue for a period of 25 years, and it contained a provision authorizing an assignment of the contract by the Woolseys in whole or in part. At the time of the assignment and sale of the contract by the Woolseys, there remained a period of approximately 19 years of the 25 years originally agreed upon. The Government contended that the gain from the sale . . . was ordinary income rather than a capital gain and asserted tax deficiencies. These deficiencies were paid by the plaintiffs, claims for refund were filed and denied, and thereafter this suit for refund was filed.

The taxpayers urgently insist that the sale involved was a sale of capital assets either under §741 or §1221-22, I.R.C. of 1954. The taxpayers vigorously contend that they sold a complete partnership interest which is a capital asset entitled to long term capital gains treatment as provided by §741; and they claim that §751 does not apply because there were no (1) unrealized receivables, or (2) inventory items which have appreciated substantially in value. The taxpayers lay much stress on the fact that the sale was of "a partnership" and "a going concern," and therefore contend that the entire transaction must be treated as the sale of a capital asset. It is strenuously argued that under the facts in this case the consideration should not be comminuted, fractionalized or fragmented and allocated to the various component parts of the "bundle" of rights and interests transferred.

Although the taxpayers set forth persuasive and ingenious arguments, we cannot agree with them.

In analyzing the problems presented by this case, it is appropriate to state that the courts have long held that the term "capital asset" is to be narrowly construed and defined. The term connotes the investment of money in property with a resulting appreciation in value accruing over the requisite length of time, and the statute is designed to lessen the hardship of taxing such appreciation in one year. Hort v. Comm., 313 U.S. 28; Corn Products Co. v. Comm., 350 U.S. 46; Comm. v. Gillette Motor Co., 364 U.S. 130. Throughout the Revenue Code there are exclusions and exception to the statute authorizing capital gains treatment. Section 751 is an illustration of such exclusions. While the term "capital asset" is to be narrowly construed, the exclusions or exceptions from the operations from the operation of the capital gains statute are to be broadly and liberally construed. Corn Products Co. v. Comm., supra.

Intricate and complicated problems are presented in applying the recognized rules to the facts in each case. Fundamental to a proper decision in each case, and to the application of well recognized rules, is a determination of the type and nature of the underlying right or property assigned or transferred. It is always pertinent to inquire how the proceeds to be received would have been taxable if there had been no assignment of the contract. Close scrutiny is required if the consideration received is actually a present substitute for what would have been ordinary earned income in the hands of the assigning taxpayer, if the assignment or transfer had not been made. A mere "sale or exchange" does not convert a right to earn income in the future which would be taxable as ordinary income to the taxpayer, into a capital gain. See Mertens Law of Fed. Income Tax., Vol. 3B, §2212, pp. 59-60.

The taxpayers have thoroughly impressed upon us their strong reliance upon §741 dealing with the capital asset provision in the sale or exchange of an interest in a partnership; but we cannot escape the conclusion that the taxpayers have over-emphasized §741 and have de-emphasized the exceptions to it as set forth in §751. The existence of a partnership does not result in the creation of a sovereign alchemist that can transmute ordinary income into a capital asset. When we look at the underlying right assigned in this case, we cannot escape the conclusion that so much of the consideration which relates to the right to earn ordinary income in the future under the "management contract," taxable to the assignee as ordinary income, is likewise taxable to the assignor as ordinary income although such income must be earned. Section 751 has defined "unrealized receivables" to include any rights, contractual or otherwise, to ordinary income from "services rendered *or to be rendered*" (emphasis added) to the extent that the same were not previously includable in income by the partnership, with the result that capital gains rates cannot be applied to the rights to income under the facts of this case, which would constitute ordinary income had the same been received in due course by the partnership. Roscoe v. Comm., 5 Cir. 1954, 215 F.2d 478; Wiseman v. Halliburton Oil Well Cementing Co., 10 Cir. 1962, 301 F.2d 654; Holt v. Comm., 9 Cir. 1962, 303 F.2d 687; United States v. Edison, 5 Cir. 1962, 310 F.2d 111. As stated by Judge Friendly in footnote 3 in *Ferrer,* after summarizing numerous cases dealing with the problem:

> These cases could well have been decided on the basis that the taxpayer held only a contract right giving him an opportunity to earn future income.

It is our conclusion that such portion of the consideration received by the taxpayers in this case as properly should be allocated to the present value of their right to earn ordinary income in the future under the "management contract" is

subject to taxation as ordinary income. This conclusion is not affected by the fact that the management contract was owned by a partnership. To paraphrase a statement from C.I.R. v. P. G. Lake, Inc., 356 U.S. 260: In short, consideration was paid for the right to earn and receive future income, not for an increase in the value of the income producing property.

We further conclude that while the assets sold may have consisted mainly of the "management contract," the consideration for which must be treated as ordinary income, capital assets also appear to have been transferred and sold. We refer to such apparent capital assets as operating records of the company; good will; and the state-wide charter. C.I.R. v. Killian, 5 Cir. 1963, 314 F.2d 852. In our opinion, part of the consideration involved requires taxation as ordinary income, and another part of it apparently requires capital gains treatment; and therefore, the consideration involved should be comminuted into its fragments and the purchase price or consideration should be allocated among the various assets sold. Williams v. McGowan, 2 Cir. 1945, 152 F.2d 570. . . .

While we are aware of the fact that it will be difficult to fragmentize the consideration, the difficulty of the task is no answer to the problem. Perfect accuracy cannot and is not expected. As stated in *Ferrer,* ". . . roughly hewn as the decision may be, the result is certain to be fairer than either extreme. . . ." (Accordingly, we Reverse and Remand to the trial court for the purpose of determining what portion of the consideration received by the taxpayers should be allocated to the "management contract" to be taxed as ordinary income; and what portion thereof should be allocated to other assets transferred which may be determined to be capital assets qualified for capital gains treatment. Further evidence will be required unless the parties can agree upon a practical solution of the problems presented.

Reversed and remanded.

NOTE

1. *Partnership interests as "capital assets."* Section 741 provides that gain or loss on the sale or exchange of a partnership interest shall be considered as capital gain or loss, except as provided in §751 (relating to unrealized receivables and substantially appreciated inventory). Before the enactment of §741 in 1954, partnership interests were treated as "capital assets" by the case law, but the government sometimes endeavored to allocate part of the sales proceeds to the selling partner's pro rata share of accounts receivable (if the partnership was on the cash basis and had not yet taken them into income), unbilled fees for services already performed, etc., and to treat this part of the proceeds as ordinary income. In a leading case involving a sale of an interest in a law partnership, such an attempt to split up the sales price was rejected by the court:

> The Commissioner here attempts to segregate partnership accounts receivable and unbilled fees for work in process and arbitrarily label both past earnings. The Commissioner argues that fees billed but uncollected, together with potential fees for work in process but not ready for billing or collection were taxpayer's "distributive share of partnership earnings" and therefore not a part of his partnership interest. We cannot agree. . . .
>
> Taxpayer was on a cash receipts basis, as was the partnership. Uncollected fees for work in process not yet completed had not been transformed on the date of taxpayer's sale of his interest into gross income within the meaning of [§183(b)(2), 1939 Code].
>
> In various of the cases heretofore cited listed among the partnership assets were such items as accounts receivable, rents receivable and unfinished work which in due course would yield gross income to the partnership. Nevertheless the various Court of Appeals and also the Tax Court treated the partnership interest as a whole, with-

out regard to the nature of the underlying assets, and held the interest to be a capital asset. [Swiren v. Commissioner, 183 F.2d 656, 660 (7th Cir. 1950), cert. denied, 340 U.S. 912.]

One judge dissented:

> . . . It cannot be gainsaid that fees earned for services performed constitute ordinary income, and that upon petitioner's withdrawal from the partnership, he had the right to receive his distributive share of the uncollected fees, or past earnings, of the partnership. Had he remained a partner, his share of the fees would have been taxable as ordinary income to him when collected. Helvering v. Smith, 2 Cir., 90 F.2d 590, and Doyle v. Commissioner, 4 Cir., 102 F.2d 86. Compare Helvering v. Horst, 311 U.S. 112; Helvering v. Eubank, 311 U.S. 122; and Austin v. Commissioner, 6 Cir., 161 F.2d 666. The courts have said that the sale of a right to receive ordinary income is not the sale of a capital asset. This is so even if the sale is of something which may be termed "property." In such a situation the sale price simply replaces the future income, but the sale price does not convert the ordinary income into capital gain. Horst v. Commissioner, 313 U.S. 28. The rule is illustrated by a decision holding that when a dividend on corporate stock has been declared, a sale of the dividend rights prior to the time the dividend is payable results in ordinary income and not capital gain. Rhodes' Estate v. Commissioner, 6 Cir., 131 F.2d 50. [183 F.2d at 661.]

Some courts rejected the *Swiren* view, however, and required a portion of the sales proceeds to be allocated to the partner's pro rata share of various "ordinary income" assets. For a review of the cases, see Sherlock v. Commissioner, 294 F.2d 863 (5th Cir. 1961).

2. *"Unrealized receivables" and "substantially appreciated inventory."* The term "unrealized receivables" is defined by §751(c) to include "any rights (contractual or otherwise) to payment for . . . services rendered, or to be rendered," if not already taken into income. In the case of a law firm, would this definition include the value of work already completed if the firm's fee is dependent upon the outcome of litigation or is discretionary with a court? See Wolcott v. Commissioner, 39 T.C. 538 (1962) ("unrealized receivables" includes amounts to be earned by architectural firm under contracts to be performed in the future); Roth v. Commissioner, 321 F.2d 607 (9th Cir. 1963) (profits to be realized under contract for distribution of motion picture).

The special treatment of substantially appreciated inventory items under §751 limits the use of the "collapsible partnership" as a substitute for the "collapsible corporation," now outlawed by §341, supra page 683. Previously it had been thought by some practitioners that partners could dispose of appreciated inventory held by a partnership at the capital gain rate by selling their interests in the firm instead of allowing the firm to sell the underlying property. See Axelrad, Collapsible Corporations and Collapsible Partnerships, 1960 So. Calif. Tax Inst. 269.

When §1245 (recapture of depreciation) was enacted in 1962, the definition of the term "unrealized receivables" in §751(c) was enlarged to include §1245 property to the extent of the §1245 gain that would be realized if it were sold by the partnership as its fair market value. A similar change was made in 1964 with the enactment of §1250 (recapture of depreciation on real property).

3. *Installment obligations.* In Rev. Rul. 60-352, 1960-2 C.B. 208, the Internal Revenue Service ruled that a limited partner who donated his partnership interest to a charitable organization realized income to the extent of his share of the partnership's "installment obligations." Under §453(d), a disposition of such obligations by gift is a taxable occasion, and the Service held that the taxpayer transferred his interest in the obligations along with his interest in the partnership:

> In G.C.M. 26379, C.B. 1950-1, 58, the Internal Revenue Service accepted the view of prevailing court decisions that, with stated qualifications, the sale of a partnership interest should be treated as a sale of a capital asset for Federal income tax purposes, rather than as a sale of the partner's undivided interest in each and every asset owned by the firm. This does not mean, however, that a partnership was thereafter treated as an entity for income tax purposes as is a corporation. On the contrary, it is still held that the members of a partnership, whether general or limited partners, jointly

own all of the partnership assets, including items of gross income, even though the provisions of the Code enabling the partnership to adopt its own accounting period and accounting method for information return purposes might cause such items of partnership income to be reflected in the individual tax returns of the partners in years other than those in which they would have been reported if the partnership had not intervened.

Thus, while the partnership interest generally may be regarded as constituting a partner's interest in the profits and surplus of the partnership, the fundamental principles of Federal income taxation require that an interest in income earned by the partnership which has not been realized, or has not yet been subjected to taxation, be treated as distinct from any "partnership interest" which is recognized as a capital asset for income tax purposes. Therefore, unrealized or untaxed rights to partnership income may be transferred with, but not as a part of, the partnership interest which constitutes a capital asset.

Is this theory consistent with the approach of §751(a), or does §751(a) assume that the transfer of the partnership interest embraces the firm's unrealized receivables?

4. *Sale of partnership interest or sale of partnership business?* Section 741 speaks of a sale or exchange "of an interest in a partnership." Did the court in *Woolsey* view the transaction as (a) a sale by the taxpayers of their interests in the partnership, (b) a sale by the partnership of its assets, followed by a distribution of the sales proceeds to the partners in liquidation of their partnership interests, or (c) a liquidating distribution of the assets of the partnership, followed by a sale by the partners of the property received in liquidation? For the treatment of liquidating distributions by partnerships, see page 764 infra. Consider also, on the problem of classifying an ambiguous transaction, the possible relevance of the *Court Holding Co.* and *Cumberland Public Service Co.* cases, supra pages 675 and 676.

5. *Reference.* Costelloe, Problems Under Section 751 upon Current and Liquidating Distributions and Sales of Partnership Interests, 15 N.Y.U. Inst. on Fed. Taxation 131 (1957).

FORD v. COMMISSIONER
6 T.C. 499 (1946)

LEECH, Judge: . . . The issues are: (1) Whether the cost basis of partnership assets should be adjusted upon the purchase of the interest of a withdrawing partner. . . .

On December 29, 1932, petitioners, together with Sara C. Ford, executed a written partnership agreement under the firm name of "The Luther Ford Investment Company." The activities of the partnership consisted primarily of purchasing, holding and selling securities. The share interests of the respective partners, as shown by the books, were as follows:

Sara C. Ford	9/27
Allyn K. Ford	6/27
Robert E. Ford	4/27
Lina Y. Ford	4/27
Emily B. Ford	4/27

On November 26, 1938, petitioners offered in writing to purchase, as individuals, for cash the 9/27 interest in the partnership of Sara C. Ford, for a total consideration of $134,738.69. Each was to contribute towards the purchase price an amount in proportion to his or her interest in the partnership. It was further provided that the remaining partners were to continue the business uninterrupted in the same name. On the same day Sara C. Ford duly accepted such offer. Appropriate entries to reflect the transaction were made on the partnership books. The partnership was continued in the same business under the same name without inter-

ruption. In December 1941, the partnership sold certain of its securities at a considerable loss. . . . In determining the deficiencies, respondent allowed two-thirds of the partnership's original cost plus one-third of the market value of all such securities as of November 26, 1938, the date of the purchase of the interest in the partnership of Sara C. Ford. It is respondent's position that each partner owns an undivided interest in each separate asset of the partnership and that when the retiring partner sells his interest to the remaining partners there is a purchase and sale of a specific asset. In support of his position reliance is placed upon the rationale of Henry V. B. Smith, 5 T.C. 323; City Bank-Farmers Trust Co. v. United States, 47 Fed. Supp. 98; and George H. Thornley, 2 T.C. 220. The respondent urges us to reaffirm our decision in the latter case, notwithstanding its reversal by the Circuit Court of Appeals for the Third Circuit, 147 Fed.(2d) 416. Those cases, however, involved the tax liability of a retiring partner. The issue here is the cost basis of capital assets of the partnership.

The courts have repeatedly recognized a partnership as a unit for computing the income tax liabilities of the individual members. . . . The respondent would have us abandon this well established concept. Unless the partnership was dissolved by the withdrawal of Sara C. Ford, respondent's theory, as we understand it, is that the partnership is not a juristic entity, even for income tax computing purposes, but is an association of individuals each of whom owns an undivided interest in each specific asset. We think such argument ignores the fact that Congress has regarded the partnership as a separate unit for computing income taxes. Thus, when a capital asset is acquired or disposed of, the gain or loss is that of the computing unit and not the individual partners. In the instant case four of the partners purchased the interest in the partnership from the other partner. The partnership, as such, engaged in no transaction affecting it as a computing unit. It continued after the withdrawal of the partner in the same business, under the same name, without interruption, as agreed. Realistically speaking, the only change that has taken place is that the remaining partners have acquired a greater interest in the profits and surplus when final liquidation occurs. After that transaction occurred, the partnership had the same identical assets as before. The partnership as a computing unit had neither disposed of any of its old assets nor acquired any new assets. Hence, there exists no logical reason for disturbing the cost basis to the partnership of specific partnership assets. The respondent suggests that the withdrawal of the partner whose interest was purchased on November 26, 1938, constituted a dissolution or termination of the partnership and the commencement of a new partnership. By the general rule of law, death or withdrawal of a partner dissolves the partnership, but it is competent for the parties to provide otherwise. . . .

In the instant proceeding, the offer to purchase the partnership interest specifically provided for the continuation of the partnership without interruption. The partners having legally contracted for the continuation of the partnership and having actually continued it, those facts should be recognized and effect thereto given, unless prohibited by some provision of the taxing act. We are not aware of any such prohibition. Moreover, under section 27 of the Uniform Partnership Act, which has been adopted by the State of Minnesota, it is specifically provided that a transfer of a partnership interest does not of itself dissolve the partnership.

The respondent has allowed two-thirds of the original cost, plus one-third of the fair market value of the securities sold as of November 26, 1938, when the retiring partner sold her interest, as the cost basis to the remaining partners. We think he erred. Since there was no dissolution or termination of the partnership in fact or by operation of law, we conclude that with respect to those securities sold by the partnership the original cost basis to the partnership of such securities

is the proper cost basis for determining gain or loss to the partnership and the individual partners, petitioners herein. . . .

NOTE

1. *The Ford case and §743(a) of the 1954 Code.* Assume A, B, and C each put up $10,000 to form a partnership. The $30,000 is invested by the firm in securities and, at a time when the securities are worth $75,000, A buys out C for $25,000. The *Ford* case holds that on a sale of the securities by the firm, A has $30,000 and B $15,000 of gain. This result can be justified as to B, who has invested $10,000 and now owns a one-third interest in $75,000. But A has invested $35,000 and has a two-thirds interest in $75,000. How can his taxable gain of $30,000 be reconciled with the fact that he has had an economic gain of only $15,000? Note that the discrepancy would be offset by a (capital) loss on liquidation: since A now has a basis of $65,000 for his partnership interest (investment of $35,000 plus $30,000 of unwithdrawn but taxed income), but will receive only $50,000 in liquidation, he will realize a loss of $15,000.

The result in the *Ford* case is endorsed by §743(a) of the 1954 Code.

2. *Elective adjustment of partnership basis under §743(b) of the 1954 Code.* Section 743(b), new in the 1954 Code, permits the partnership to elect to adjust the basis of the partnership property "with respect to the transferee partner only." Upon electing under §734(b), the basis of the partnership property as to A would be $20,000 (i.e., his two thirds of the partnership's basis) plus $15,000 (the excess of the basis of his partnership interest, $35,000, over his share of the partnership's basis, $20,000), or a total of $35,000. Upon a sale of the property for $75,000, A's gain will be $15,000 (his two thirds of the sales price, less his $35,000 basis as adjusted under the §743(b) election), while B's gain would be $15,000 (his one third of the proceeds, less his one third of the partnership basis).

A similar adjustment to basis is authorized in the case of the death of a partner. Before 1954, although the value of the deceased partner's interest at the date of his death was included in his estate in calculating the estate tax, the basis of the property of the firm was not adjusted; so that income was realized by the estate or the heir upon a subsequent sale of the property by the firm at its estate tax value. First National Bank of Mobile v. Commissioner, 183 F.2d 172 5th Cir. 1950).

SECTION D. PARTNERSHIP LIQUIDATING DISTRIBUTIONS

CARTER v. COMMISSIONER
36 B.T.A. 60 (1937)

[The petitioners and Robert Burkham, deceased, were partners in the practice of law under an agreement, executed in 1927, providing:

[I]n the event of the death of any member of the firm, his heirs, executor or administrator shall receive from the firm a sum equal to one-half of the amount actually received by such deceased partner during the two calendar years next preceding such death, said sum to be paid in equal monthly installments without interest, for a period of twelve months. . . . Such payment shall be in lieu of all interest which the heirs, executors or administrators of such deceased partner may have in any fees received by the firm subsequent to the date of such death . . . and in full payment of the interest of such deceased partner in the library and office equipment of the firm.

Each member of the firm hereby agrees in the event of his death that no administration of the firm or its assets shall be required, and waives all right thereto and agrees that the payment made to his heirs, executors or administrators as above provided, shall be taken and received by them in full payment for his interest in the firm and its assets.

[Upon the death of Robert Burkham, the payments required by the agreement were made to his estate.]

HILL: Petitioners allege that respondent, in determining the deficiencies, erred in treating as distributable income of the partnership [a law firm] and including in taxable income of each of the petitioners, other than the estate of Robert Burkham, deceased, their respective proportionate interests in the amount paid to the estate of decedent during the taxable year, pursuant to the partnership agreement of January 1, 1927. Substantially, the position of the petitioners is that the sum paid to the deceased partner's estate was that portion of the income from fees received by the partnership which was due the decedent's estate, and was received by the partnership as trustee for such estate.

The facts were stipulated by the parties, and on this issue, among other things, it is stated that neither of the petitioners nor any members then constituting the co-partnership

> received any part of the sum . . . paid to the estate of Robert Burkham, deceased, but pursuant to the terms of the agreement of January 1, 1927 herein referred to, said sum was received by the co-partnership with the duty imposed to pay the same to the said estate of Robert Burkham, deceased, which duty was duly performed, as aforesaid.

The meaning intended to be expressed in the quoted stipulation . . . is not entirely clear, but we need not construe it. If it was meant to say that the money out of which the sum in controversy was paid to the decedent's estate was not first "received" by the partnership it is contrary to the facts otherwise clearly established by the record and must be rejected. William Ernest Seatree, 25 B.T.A. 396; Volunteer State Life Insurance Co., 35 B.T.A. 491. If the parties intended to stipulate that the sum was received by the partnership not as its own property but in trust for the estate of the deceased member, then the stipulation amounts to a legal conclusion and must be disregarded. . . .

It is conceded by all parties that the death of Robert Burkham dissolved the old partnership, and that the new partnership organized by the surviving members paid the amount in controversy to the decedent member's estate under and pursuant to the terms of the partnership agreement of January 1, 1927; also that the principal purpose of the agreement was to eliminate a partnership administration upon the death of a partner and an accounting over a long period of time by the surviving partners.

Solution of the problem presented here depends upon whether the sum paid to Burkham's estate represented his share of fees earned by the partnership prior to but uncollected at the time of his death, or whether such payments constituted the consideration paid by the surviving members for Burkham's interest in the old partnership and its assets. Bull v. United States [infra p. 1090].

The conclusion seems inescapable to us that by the payment of a definitely ascertainable consideration, which is the amount here in controversy, the surviving partners of the old partnership purchased all of the interest of the deceased Burkham in the firm and its assets. The parties have stipulated that one of the purposes of the partnership agreement was to fix at death a definite sum for payment to the estate of a deceased member, regardless of whether, in the absence of such agreement, the amount payable to the deceased partner's estate for his interest in the partnership would have been greater or less than the amount fixed by the agreement.

Whether the interest of the deceased Burkham had in fact a fair value of more or less than the amount paid under the contract, and whether or not the survivors derived a profit from their purchase of his interest for such sum, does not appear from the record. No question is raised on this point. Likewise, it does not appear what assets, if any, the partnership owned other than a library and office equip-

ment of undisclosed value. The petitioners offered no evidence as to these matters. But in the state of the record before us, they are in any event immaterial.

The fact remains that the surviving partners purchased the interest of Burkham in the firm and its assets, for a stated consideration. Thereupon, they became the exclusive owners of all uncollected fees, whether the services for the rendition of which such fees were received were performed either prior or subsequent to his death. It was out of such fees that the amount in question was paid to Burkham's estate. The amount, therefore, constituted distributive income of the new partnership when received, and is taxable to the petitioners to the extent of their respective interests, whether in fact distributed to them or not.

The partnership did not act in a fiduciary capacity in respect of any of the fees collected after the death of Burkham. His estate had no interest therein. Under the partnership contract it had only the right to demand payment of the stipulated amount. It was not entitled to payment out of fees; and in case no fees had been collected within the time fixed for payment, the estate would still have been entitled to receive the amount agreed upon, and the partnership could have fully discharged its obligation by payment out of any fund, whether or not it embraced fees collected subsequent to Burkham's death. . . .

The conclusions reached above are not in conflict with our decision in Gussie K. Barth, 35 B.T.A. 546. The latter case is distinguishable on the facts. There the partnership contract provided that "the partnership shall not be immediately dissolved by reason of the death of a partner but his interest therein shall be determined" by payments to his widow for a period of three years of specified percentages of what would have been the deceased partner's distributive share in the proceeds from the business if he had remained alive. The amount received by Barth's widow did not represent payment for capital assets. In the instant case, the old partnership owned tangible assets and the amount paid to the decedent's estate was for his interest in the old partnership, including such assets.

Furthermore, in the *Barth* case, the question presented was whether the amount paid by the surviving partner constituted income taxable to the widow of the deceased partner. Here the question is whether the amount paid to the decedent's estate by the surviving partners, having been paid out of income (that is, out of fees collected by them), constituted distributive income taxable to the members of the new or succeeding partnership. Since the transaction before us was clearly a purchase and sale of the deceased partner's "interest in the old partnership and its assets," the consideration paid by the new partnership out of income is taxable to the members of that partnership, whether or not the consideration so paid also represents *in whole or in part* taxable profit to the decedent's estate. In no event, therefore, does the *Barth* case rule the decision in the instant case.

HALL v. COMMISSIONER

19 T.C. 445 (1952)

TIETJENS, Judge: The partnership of Touche, Niven & Company paid certain amounts during its fiscal year ended September 30, 1947 to Whitworth, Clowes, and the estate of Victor E. Stempf. The sole issue is whether $48,668.26 of these amounts was paid as part of the purchase price of the interests of these former partners, or as a distribution of profits, as income, to the retired partners and the estate. . . .

The payments in controversy were part of a total of $288,433.26 which the administrative partners had agreed to pay Whitworth, Clowes, and the estate of Stempf under the partnership agreement of 1936, which was in effect at the times Whitworth and Clowes retired and Stempf died. This agreement provided

that the death or retirement of a partner should not dissolve the partnership between the remaining partners and required the continuing partners to make certain payments to the retired partners or estates of deceased partners. The continuing partners were required by Article XI, section 1, to repay any loan made the firm by the former partner, as well as his current account balance and his share of the past distributable profits. His paid-up participation in the stated capital was to be repaid in installments with interest. Article XI, section 2, provided that in case of the death of a partner, or his retirement at age 65 there was to be paid, in addition, an amount to be fixed by the administrative partners, which amount was to be measured by the former partner's share in earnings in past years or the share he would have had in the next 3 years' profits had he continued as a partner; it was to be paid out of distributable profits in installments over a period of 6 years; and the agreement stated the payment "is intended as a distribution of income to the retiring partner or the estate of a deceased partner for a limited period subsequent to his retirement or death." In section 3 of Article XI, authority was given the administrative partners to pay such sum as they might deem advisable in the case of any partner retiring before reaching age 65, or withdrawing for any other reason.*

The solution of the question depends upon the intent of the parties and that is to be derived from the 1936 partnership agreement. Despite contrary arguments, we think the payments here involved were made pursuant to section 2 of Article XI of that agreement and, accordingly, are controlled by that section. . . .

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* "Section 2. If any partner shall retire pursuant to Section 2 of Article X hereof after attaining the age of sixty-five years or shall die at any age, there shall be payable, in addition to the amounts hereinbefore provided in paragraphs (a), (b) and (c) of Section 1 of this Article XI, to such retiring partner, or to the personal representatives of such deceased partner, out of distributable profits, such amount as may be determined by the decision of a majority in interest of the Administrative partners but in no event less than the smaller of the following:

"(a) an amount equal to three (3) times the annual average of the sum of the salary plus the distributable profits of the partnership which such deceased or retiring partner received or was entitled to receive in respect of the business of the partnership carried on during the ten (10) fiscal years of the partnership next preceding the fiscal year in which such partner died or retired; or

"(b) an amount equal to the sum of the salary plus the distributable profits of the partnership to which such deceased or retiring partner would have been entitled, if he had not died or retired and if his ratio in the profits of the partnership had not been altered, in respect of the business of the partnership carried on during the three (3) succeeding fiscal years of the partnership, including the fiscal year in which such partner died or retired, but for the purposes of this subdivision (b) the distributable profits shall be determined after deducting current salaries and current interest on capital of any additional partners as well as those of the surviving or continuing partners.

"The amount so determined to be payable shall be payable, without interest, in six (6) equal annual instalments, the first of which shall become payable at the expiration of one (1) year from the date of death or retirement or at such earlier date as a majority in interest of the Administrative partners may determine, but, unless the distributable profits then available shall not be sufficient, no annual instalment payment during each of the first three (3) years after such death or retirement shall be less than fifty per cent (50%) of the annual salary of such deceased or retired partner at the date of his death or retirement, or less than five thousand dollars ($5,000) per annum.

"The payment under this Section 2 is intended as a distribution of income to the retiring partner or the estate of a deceased partner for a limited period subsequent to his retirement or death.

"The provisions for the payment to be made under this Section 2 of this Article XI are limited to the cases specifically provided for hereunder and do not apply to any partner who retires or withdraws at any other age or for any other cause.

"Section 3. Notwithstanding any of the provisions of this Article XI, by decision of a majority in interest of the Administrative partners, there may be paid such sum of money in such instalments as they shall deem advisable to any partner retiring before he attains the age of sixty-five (65) years or to any other partner who may withdraw for any other reason." — Ed.

The payments, being made pursuant to section 2, are subject to certain other provisions of that section. They were to be made "out of distributable profits" and they were "intended as a distribution of income to the retiring partner or the estate of a deceased partner for a limited period subsequent to his retirement or death." Also, it was provided that no annual installment in the first 3 years should be less than 50 per cent of the partner's annual salary at death or retirement or less than $5,000, "unless the distributable profits shall not be sufficient." Thus the payments were keyed to the existence of profits, and the intent appears that a partner who retired, or the estate of a partner who died, was to continue for a time to participate in the profits on the same basis and in approximately 50 per cent of the amount as before the event. We find no language in the written agreement which would justify a conclusion that the retiring partners intended to "sell" their interest in the partnership to the continuing partners, or vice versa, that the continuing partners intended to "buy" the retiring partners' interests.

The case of Charles F. Coates, 7 T.C. 125, is here apposite. There are factual differences, but we do not think them significant. Respondent has acquiesced in that case, 1946-2 C. B. 2. Coates was a continuing partner in an accounting firm which provided in the partnership contract that the death of a partner should not operate to dissolve the co-partnership, that the estate should continue as a member for 5 years with no direct voice in management, that the estate should participate in the net earnings in stated proportions and not be liable for losses, that the deceased partner's "capital interest" should be settled as soon as possible, and that at the end of 5 years and the completion of the payments the interest of the deceased parties should terminate. No partner had contributed any capital and capital was not important in that personal service organization. The "capital interest" consisted of (1) the pool of undrawn earnings (the amount withdrawn having been limited to 85 per cent of each partner's share for the previous year) and (2) the value of the work then in process. We noted that since the agreement provided for the return of any remaining interest in the firm's assets it was difficult to find evidence of an intent to sell the interest of the deceased partner, that the parties placed no value upon the good will and partnership name and that ordinarily no substantial value attaches to good will of such a personal service partnership. We said further:

In addition to the provisions for the return of the "capital interests" to the estates are the provisions with which we are here concerned for participation by the estate of a deceased partner in the earnings of the partnership for five years after the partner's death. These payments have no relation to the other type of payments provided for the liquidation of the capital account. They provide simply that the estate of any deceased partner shall participate to the extent there provided in the net earnings of the partnership for a period of five years. The evidence establishes that this provision was intended by the parties not to be the consideration paid by the surviving partners for the capital interest of a deceased partner upon the dissolution and liquidation of the partnership, but was intended to be a present consideration given by each partner upon the formation of the partnership. It was intended to be in the nature of a mutual insurance plan, the disadvantage of which each partner was willing to accept in consideration of a similar commitment for his benefit on the part of all other partners, and, in part, as further compensation for the past services of the deceased partner payable after his death.

These payments were not made in liquidation of any capital interest of the deceased partner in the firm's assets. The only payments of this nature required upon the death of a partner were the payments on account of past earnings and work in process, here designated as the "capital account." In addition to these payments, the estate of a deceased partner was entitled to the payment of a share of post death earnings, not in consideration of a sale of partnership assets on liquidation, but in consideration of mutual promises

contained in the original partnership agreement having no relationship to such a sale. These payments arose out of and depended upon the contract and their character must be determined by its terms. The estate acquired, upon the death of the partner, a vested contractual right to a share of the earnings, as earnings, and this right was fortified by a power lodged in the trustee to require a liquidation of the business if its rights were not fully respected by the surviving partners. When and as the income was earned, it became immediately subject to the preexisting rights of the estates to their share of it. The amounts so distributable to the estates were not distributable to any surviving partner, with the result that here, as in Richard P. Hallowell, 2nd, supra, the disputed amount attributed by the respondent to each surviving partner may not be regarded as "his distributive share, whether distributed or not, of the net income of the partnership."

The case of Richard P. Hallowell, 2nd, 39 B.T.A. 50, referred to in the above quotation, is also in point. There, the agreement provided that the interest of the estate of a deceased partner should be deemed a loan and that the estate should have the same interest in profits the deceased partner would have had if living, until the termination of a period agreed upon. Since settlement of the capital interest was to be accomplished under other provisions of the agreement, we concluded that the estate shared in profits as a matter of right under the contract. See also Sidney Hess, 12 T.C. 773, and cf. Estate of Boyd C. Taylor, 17 T.C. 627.

Clowes and Whitworth, and respondent in this proceeding, rely upon certain cases to the effect that where the partners agree that a deceased partner's interest shall be acquired by the surviving partners by payments of firm profits to his estate, there is a sale of the interest and the profits so paid are taxable to the survivors and represent the purchase price of a capital asset. See Hill v. Commissioner (C.A. 1, 1930), 38 F.2d 165; Pope v. Commissioner (C.A. 1, 1930), 39 F.2d 420; W. Frank Carter, 36 B.T.A. 60 (1937), and Estate of Bavier C. Miller, 38 B.T.A. 487 (1938). In these cited cases the deceased partners had made a capital investment in the partnership which was not repaid to their estates, but was transferred to the surviving partners in consideration of the payments involved. In the present case the capital investments of the deceased or retiring partners were returned to them in full pursuant to section 1(c) of Article XI. Payment of the distributable profits for the current year of retirement or death was also provided for in section 1(b) of Article XI. The payments provided for in section 2 or 3 of that Article were additional and distinct. Since they could not be a return of capital they could be only distributions of income. We think these cases are distinguishable on their facts. No sale or purchase of partnership interests was here intended. See Bull v. United States, 295 U.S. 247 (1935).

Clowes and Whitworth contend that the partnership had good will of a considerable value and working papers which were an asset in their business, that the interest of the retiring partners in these items was the subject of a sale in the transfer of their interests to the continuing partners and that the payments in controversy were intended as the purchase price of these assets. This argument is not borne out by the agreement. Article IV provides that a deceased, retiring, or withdrawing partner shall have no interest in the firm name and no right to receive any payment therefor. As to the good will, in the first place it is inextricably associated with the firm name and not transferable otherwise, and in the second place the good will of a personal service organization such as this, is rarely a vendible article. Charles F. Coates, supra. As for any good will attaching to Whitworth or Clowes individually and separate from firm good will, these retiring partners made no agreement not to compete with the firm and hence must be deemed not to have relinquished or transferred it, if indeed it could be transferable. The firm in its financial calculations at no time placed any value upon the

firm name, good will, or working papers. Nor do we find anything in the agreement disclosing any intention to value good will as such or to make any payments in consideration of the sale thereof to the surviving partners.

We think that the partners in entering into the 1936 agreement, intended that a retired partner, or the estate of a deceased partner, should share in the profits of the firm, as profits, for a limited period after the event, that the provision was in the nature of a mutual insurance plan in which each partner assumed its possible burdens in consideration of the assumption of a like obligation by his partners to him, and that the payments here in controversy were properly deducted by the continuing partners in determining the distributable partnership income taxable to them.

Because of conceded adjustments,

Decision will be entered under Rule 50.

NOTE

1. *Liquidating payments to retiring or deceased partners under the 1954 Code.* In 1954, because "existing case law presents no consistent approach" to the tax treatment of payments to retiring or deceased partners (S. Rept. 97), Congress enacted §736 as a statutory guide to this area. The *Carter* and *Hall* cases should be re-examined with §736 in mind. Assuming a payment in cash (a payment in property presents added complications, though the basic principle is the same), §736(b) provides for segregating the portion that is paid "in exchange for the interest of such [retiring or deceased] partner in the partnership property." This may not include any amount paid for goodwill, unless the partnership agreement provides for such a payment, or for unrealized receivables. The amount thus paid for the partner's interest is treated as a distribution by the partnership, and hence is subject to the rules of §731; so far as the retiring partner or the successor in interest of the deceased partner is concerned, and assuming no substantially appreciated inventory is involved, this means that capital gain or loss will be recognized to the extent of the difference between the amount received and the basis of the retiring or deceased partner's interest. Conversely, the continuing partners may not deduct the payments.

Liquidating payments that are not paid "in exchange for the interest of such [retiring or deceased] partner in the partnership property" (as just defined) are treated as a distributive share of partnership income if the amount is determined by reference to the partnership's income, and otherwise as guaranteed payments. In either event, the payments will be taxed as ordinary income to the recipient and will be either excluded or deducted so far as the continuing partners are concerned.

Of special importance is §731(b)(2)(B), under which a payment for goodwill falls on the ordinary income side of the line "except to the extent that the partnership agreement provides for a payment with respect to good will." Must the agreement expressly label the payment, or can a taxpayer prove independently that a payment was intended as compensation for goodwill? See Smith v. Commissioner, 313 F.2d 16, 20, 21 (10th Cir. 1962), citing the *Lester* case, supra page 184, in holding that the agreement must be explicit:

> [The reasoning of the *Lester* case] would appear to be particularly applicable here and we think the payment in question should be treated as ordinary income rather than capital gain since the articles of partnership do not specifically provide that the payment is for goodwill. If intent is to be determined by something other than the plain language of the partnership agreement, uncertainty and confusion will becloud the issue and the efforts of Congress to clarify a complex situation will go for naught. Important, also, is the fact that this result treats fairly both the expelled partner and the remaining partners as the tax consequences are determined in advance by the contract to which they all agreed.

See also Jackson Investment Co. v. Commissioner, 42 T.C. No. 67 (1964) (original partnership agreement did not provide for goodwill payments; held, later agreement to make

payment for goodwill does not constitute an amended partnership agreement within meaning of §761(c), so as to satisfy §736(b)(2)(B)'s requirement of a provision in "partnership agreement").

If the agreement of a professional partnership explicitly provides that a payment is for goodwill, however, may it be disregarded in whole or in part in the light of Rev. Rul. 57-480, supra page 575, and Rev. Rul. 60-301, supra page 576?

Suppose the agreement provides that upon the death of a partner, his entire interest in the firm's assets and earnings shall cease, and that a "death benefit" shall be paid to beneficiaries named by him, either in a stated sum or in an amount equal to a specified percentage of the firm's previous or subsequent earnings for a stated period. Is §736 applicable? Does it apply to an agreement providing that upon the death of a partner, his executor may elect to continue as a partner for a limited period, receiving a stated percentage of the firm's profits, with the estate having no further claim of any kind on the firm's assets or earnings?

2. *Liquidation vs. sale of partner's interest.* Note that "payments made in liquidation of the interest" of a retiring or deceased partner under §736 are taxed differently from the proceeds of a "sale or exchange of an interest in a partnership." On a sale or exchange, the amount received will produce capital gain or loss in its entirety under §741, except for the amount, if any, attributable under §751 to unrealized receivables or substantially appreciated inventory items. Supra page 761. A major distinction between the two approaches lies in the treatment of a payment for goodwill. Such a payment will produce ordinary income under §736, unless it is provided for in the partnership agreement, and even then the Senate Report (p. 395) states that the payment "may not exceed the reasonable value" of the partner's interest in goodwill. See again what is said about goodwill in the *Hall* case. Under §§741 and 751, however, a payment for goodwill is not taxed as ordinary income when a partnership interest is sold or exchanged.

Section 736 deals only with "payments made in liquidation of the interest" of a retiring or deceased partner, and by virtue of §761(d) this phrase is restricted to a distribution, or a series of distributions, "to the partner by the partnership." Payments by others are governed by §§741 and 751 rather than by §736. Note the statement in the *Carter* case that "the surviving partners of the old partnership purchased all of the interest of the deceased Burkham in the firm and its assets"; similarly in the *Hill* case, cited by the court, the partnership agreement "provided for the sale of the interest of a deceased partner to the surviving partners." Would the payments in these cases be governed by §736 or by §741? Is there a difference between selling the retiring or deceased partner's interest to the surviving partners in proportion to their respective interests in the firm, and a liquidation of the partner's interest under §736? See Regs. §1.736-1(a)(1)(i); Foxman v. Commissioner, 41 T.C. No. 51 (1964) (transaction treated as sale of partnership interest to two remaining partners, rather than a liquidation).

3. *Optional adjustment of basis on partner's death.* The election under §743, discussed supra page 764, in connection with transfers of partnership interests, is also applicable on the death of a partner.

4. *References.* Little, Partnership Distributions Under the Internal Revenue Code of 1954, 10 Tax L. Rev. 335, 350 (1954); Egger, Sales of Partnership Interests and Death or Retirement of Partner, 15 N.Y.U. Inst. on Fed. Taxation 115 (1957); Bauman, Income in Respect of a Deceased Partner, 1963 So. Calif. Tax Inst. 383; Bromberg, Taxable Income Without Gain on the Sale of a Deceased Partner's Interest: Code, Common Law, and Community Property, 13 Sw. L.J. 343 (1959); Phillips, Elections under 1954 Code Affecting Changes in Partners' Capital, 2 J. Taxation 262 (1955).

CRAWFORD v. COMMISSIONER

39 B.T.A. 521 (1939)

HILL: . . .

Petitioners filed this proceeding . . . for a determination by the Board of an alleged overpayment of taxes amounting to $39,883.56 for said year. . . . The facts are stipulated.

The petitioners are executors of the will of George W. Crawford, deceased. During his lifetime the decedent was a one-fourth co-owner of the Venempa Investment Co., a partnership, formed December 26, 1938, in Pittsburgh, Pennsylvania, to engage in buying, selling, and dealing in stocks, bonds, and other commercial securities. Including contributions made at the time of the partnership's organization, each of the four partners paid in to its capital cash in the amount of $262,815.96, and securities for which they were given capital credits on the partnership books. The securities contributed by the decedent included 10,000 shares of Western Public Service Corporation stock which cost him $25,200 when acquired in 1928; also, two blocks (of 1,250 shares each) of Lone Star Gas Corporation stock, each block costing $5,195.27 when purchased. The 10,000 shares of Western Public Service Corporation stock had a fair market value of $283,125 when contributed to the partnership, and decedent received a credit upon the partnership books in the amount of their cost ($25,200) for the same. The two blocks of Lone Star Gas Corporation stock had fair market values in the respective amounts of $82,812.50 and $81,250 when contributed to the partnership, and decedent received a credit therefor upon the partnership books in the respective amounts of $81,250 and $50,000.

In and during the years 1928 to 1932, inclusive, the partnership had net earnings which, for the whole period, exceeded its losses. It distributed no part of its earnings to members and, at the end of 1932, had on hand undistributed earnings, represented principally by investments in securities, of which the value of decedent's partnership interest amounted to $128,250.65. On December 31 of the latter year the partnership was dissolved by mutual consent and its assets distributed. The decedent received in this distribution $83.69 in cash and securities of a total market value amounting to $233,500.

In decedent's income tax return for 1932 no deduction from gross income was claimed for any loss sustained in liquidating his interest, as aforesaid, in the partnership. The petitioners claim, and ask us to find in this proceeding, that a loss was sustained in that transaction, and that failure to take a deduction for it in decedent's income tax return for 1932 resulted in an overpayment of taxes in the amount of $39,883.56. The issue is governed by the Revenue Act of 1932, and the pertinent provisions of Treasury Regulations No. 77.

Relating to "Readjustment of Partnership Interests," article 604 of Regulations 77, among other things, provides that when a partner retires from a partnership, or it is dissolved, the partner realizes a gain or loss measured by the difference between the *price received* for his interest and the *cost to him* of such interest, including in such cost the partner's share in undistributed partnership net income on which income taxes have been paid. Also, that if in a dissolution the partnership assets are distributed to the members *in kind and not in cash,* the partner *realizes no gain or loss until he disposes of the property received in liquidation.*

The petitioners contend that by virtue of the provision first above mentioned, a loss to the decedent through liquidation of his partnership interest is established. That this loss is the amount by which the cost of his partnership interest exceeds the cash ($83.69) and the market value ($233,500) of the assets distributed to him.

The parties are in accord on the cost of decedent's partnership interest. They also agree what the "market value" of all assets distributed to decedent was when the partnership was dissolved. However, at the time the return here involved was filed, the assets distributed to decedent had not been disposed of, and the respondent contends that, under the provision of the regulation last above mentioned, no gain or loss may be recognized until a sale or disposition of them has been made. The petitioners counter this contention with the argument that application of the provision is logical and proper, only when applied to cases where the

assets distributed in a partnership liquidation have no determinable value. They argue that where basic values are agreed upon, as in the case at bar, the actual gain or loss is ipso facto established and must be recognized under the provisions of such regulations, as well as under [§1001(a) and (b), relating to the computation of gain or loss on the sale or other disposition of property].

The petitioners also contend that the effect of respondent's holding in the premises is to place an unconstitutional construction upon and render void the provision of the regulation relied upon by him.

In pressing their argument that the challenged portion [Art. 604, Regs. 77] is illegal, and therefore void, the petitioners admit in their brief that they know of no case directly in point, but cite Helvering v. Walbridge [supra p. 752], where the court in its opinion by way of dictum referred to the provision as "of doubtful validity," except in cases where the asset dealt with had no fair market value. Petitioners also quote [Magill, Taxable Income 134-138 (rev. ed. 1945)], where that author in discussing a related phase of the problem of partnership gains refers to reasons given by the Advisory Board of the Treasury for the rule of construction here applied by the respondent, as "not wholly convincing."

In our opinion the portion of the regulation objected to by the petitioners is reasonable in its application to the facts before us and must be sustained. Obviously, the petitioners misconstrue the exact character of the transactions which, they conclude, resulted in a loss to the decedent. The net effect of petitioners' reasoning is that, when a partnership dissolves and distributes its capital assets among members, each member *disposes* of his partnership interest for a price, or that he receives such distribution in cancellation or redemption of an interest in the partnership. The fact is that such distribution does not confer title to the assets upon the members, but is merely an apportioning among them of what they already owned jointly. Petitioners' decedent and others contributed securities and cash to a fund to be used in the partnership business. The partnership operated this fund over a period of years. The net profits from such operation were taxable distributively to the members of the partnership and likewise the net losses of the operation were deductible proportionately by the members in determining their income tax liability. What remained of the fund at the dissolution of the partnership was the property of the members and was the residuum of what they had contributed to the fund. The partnership fund was at all times the property of the members and neither the dissolution of the partnership nor the distribution of the fund affected such ownership in any way.

The fallacy of petitioners' assumption is clear when one considers the character of partnerships. An ordinary partnership, such as we have here, has no entity in the sense that it may own property separate and apart from the ownership thereof of its members. The members, at all times, own the partnership business and the assets employed in it, and are, therefore, never separated from title thereto. The dissolution of the partnership in question in no way affected the title to the assets of the partnership fund but the title to such assets, which, ab initio had rested in the members, continued in them. Accordingly, the distribution of assets which took place upon dissolution of the partnership neither added to, nor took from, the economic interests of the partners. The net effect of the process was not to create new interests and values, but merely to apportion and deliver to each member, according to his ratable interest, that which represented his then investment, leaving him no richer or poorer than he was before the dissolution. Cf. William S. Gordon, Trustee, 33 B.T.A. 460, 464; J. Henry Dick Estate, 20 B.T.A. 637. Such result, of course, does not obtain where the partnership is a business syndicate beyond the direct control of the individual members. William S. Gordon, Trustee, supra. Nor, in a case where a partner sells his interest to another, or

retires from the partnership, upon an agreed consideration and the business is continued. In such cases, title to the retiring partner's interest passes to another, and a closed transaction takes place. Hill v. Commissioner, 38 Fed.(2d) 165; Pope v. Commissioner, 39 Fed.(2d) 420.

The distinction between the transaction at bar and the cases just cited by us is obvious and clear. What the decedent received in the distribution was not a consideration in exchange for his investment in the partnership fund, but his aliquot part, in kind, of the assets comprising such fund which theretofore he and his partners owned and held at risk in the business. Obviously, there was no disposition of partnership interest or of the interest of decedent in the partnership fund in this case and the provision of the regulation aptly applied to the transaction.

The petitioner's contention that the challenged provision denies to them the benefit of loss deductions otherwise allowable under the revenue acts is unwarranted by the facts. The petitioners assume that a loss must be conceded, because the stipulation shows that the market value of the assets distributed to decedent was less than his contributions to the partnership's capital plus his part of its undisbursed income. This assumption is erroneous. As hereinbefore pointed out, the assets received by the decedent on dissolution of the partnership represented his part in an investment which still exists. The fact that the investment was made through the medium of a partnership did not change its character, and the provision of the regulation, supra, which postpones realization of gain or loss until the assets are sold is obviously made to preserve such character.

The petitioners cite certain court and Board decisions which they contend support their theory that the distribution here considered must be given the effect of a sale or exchange in which a transfer of title to an interest in the assets disbursed took place. Among the cases cited in support of such theory are the Board cases of Edward B. Archbald, 27 B.T.A. 837; affd., 70 Fed. (2d) 720; Carroll E. Donner et al., Executors, 32 B.T.A. 364, and Cyrus S. Eaton, 37 B.T.A. 715; and Federal court cases, Chisholm v. Commissioner, 79 Fed. (2d) 14; and Helvering v. Walbridge, supra.

In our opinion, none of the cases so cited support the contentions petitioners here make. Rather, we think, if applicable to any phase of this controversy, the cases, in so far as they throw light, support the respondent's theory that the bare distribution of partnership assets "in kind" upon dissolution is not such a liquidation of the partner's interest as to bring into realization gain or loss to the partner. The cases cited do not deal with dissolved partnerships, or the direct question here involved. They do deal, however, with questions involving the taxability to partners, as individuals, of the increments or values by which assets contributed to the partnership capital may have increased over their initial cost of the partner.

On the latter question, the cases cited concur in holding that no gain results to the contributing partner for the increment to assets contributed in kind to the partnership until the partnership is dissolved because, until then, there is no liquidation of the assets whereby such increment can be realized as gain. Moreover, the cases hold that the ownership of partnership assets, at all times, is in the members; from which it follows that, when the assets are distributed "in kind," rather than being liquidated through sale and the cash disbursed, the partner receives, individually, his interest or part of that property which he theretofore already owned, although collectively or jointly with his copartners. If the corpus of the partnership is first reduced to cash, and the cash distributed to the member, then, of course, gain or loss may be realized as provided for in like cases of sales of property. We find no conflict in the decisions cited and the views we have

herein expressed. We think the provision in the regulation challenged is in harmony with the law and we therefore sustain the respondent's interpretation. . . .

NOTE

1. *Liquidating distributions under the 1954 Code.* The theory of the old regulation and of this case has been in general carried over by §731(a), but some modifications have been introduced.

Under §731(a)(2), a partner having a gain on a liquidation will (a) recognize it in full if the distribution consists entirely of cash, (b) recognize it to the extent that the cash exceeds the adjusted basis of his partnership interest if he receives both cash and money, and (c) recognize no gain until the property is sold if he receives only property.

A partner suffering a loss on a liquidation recognizes it if he receives only cash; but if he receives property (or property and cash), he must ordinarily postpone a recognition of the loss until the property is sold. See generally Little, Partnership Distributions Under the Internal Revenue Code of 1954, 10 Tax L. Rev. 161, 335 (1954). But if the distribution is entirely of cash, unrealized receivables, or inventory (or a combination of these items), loss will be recognized. Thus if the partner, in liquidation of an interest that has an adjusted basis of $10,000, receives $3000 in cash, and unrealized receivables and inventory with an adjusted basis to the firm of $5000, the partner will have a loss of $2000 regardless of the value of the receivables and inventory. This is because his adjusted basis for his partnership interest ($10,000) exceeds by $2000 the sum of the money received ($3000) and his adjusted basis, determined under §732(b) and (c), of the receivables and inventory ($5000). Why is the basis to the distributee partner of the inventory and receivables deliberately kept down to the firm's basis therefor, even though doing so gives him an immediate loss on the liquidation? Note §735(a) and the second sentence of §731(a).

2. *Basis of property distributed in liquidation.* If the partner's gain or loss is not recognized at the time of liquidation, it is necessary to allocate his adjusted basis for his partnership interest among the various assets received by him. Note that §732(b) and (c) does not countenance a stepped-up basis for unrealized receivables and inventory.

3. *Reference.* Janin, Current and Liquidating Distributions and Partnership Elections Under Section 754, 15 N.Y.U. Inst. on Fed. Taxation 95 (1957).

CHAPTER 9

Accounting and Income Taxation

SECTION A. ACCOUNTING METHODS

1. *Introductory*

Section 446(a) and (b), providing that taxable income shall be computed under the taxpayer's regular method of accounting unless it does not "clearly reflect income," is substantially the same as §41 of the 1939 Code.

Section 446(c), specifying certain methods of computing taxable income, is new.

Section 446(d), permitting the taxpayer to use a different method of accounting for each trade or business in which he is engaged, is new.

Section 446(e), requiring the consent of the Treasury if the taxpayer wishes to change his accounting method, is similar to Regs. 118, §39.41-2(c), 1939 Code.

AMERICAN ACCOUNTING ASSOCIATION, ACCOUNTING PRINCIPLES AND TAXABLE INCOME *

27 Accounting Review 427 (1952)

Summary

1. In the several statements of "Accounting Concepts and Standards Underlying Corporate Financial Statements" issued by committees of the American Accounting Association in 1936, 1941, and 1948, fundamental propositions concerning the functions of accounting in respect to revenue realization, costs, income, and capital were set forth. The objective in so doing was to present a coordinated statement of principles and suggested applications representing levels of accounting practice "departures from which should be viewed with concern."

2. Under the tax laws of the United States, Congress has enacted taxes on the net incomes of corporations. In the enactment of these laws and in their administration, by regulation or as a result of Court decisions, there have developed determinations of taxable income which are at variance from determinations of net income for financial statement purposes under generally accepted accounting principles.

3. These differences between taxable income and accounting net income may be classified generally into two principal categories:

(a) Differences of specification — those resulting from Congressional enactments designed to grant concessions as a matter of legislative grace or to deny or limit deductions as a matter of economic control or for purposes of raising revenue.

(b) Difference of timing — those which affect principally the time of recognition of income or of deductions, usually resulting from legalistic interpretations of the tax statutes by Court or regulative decisions (thereby setting a precedent for subsequent administration).

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4. These differences result largely from differences in purpose. The purpose of the revenue laws is to establish practical formulae for the collection of taxes (and at times to regulate the economy). Financial accounting determinations of net income are designed to measure business results as they occur, without recognizing any artificial exclusions or modifications. Despite these differences in purpose, business has sometimes allowed its accounting practices to be influenced, largely for convenience, by income tax provisions. In at least one case, also, the income tax law has undertaken to decree the procedures of financial reporting.*

5. The Committee has undertaken to examine these conditions for the particular purpose of dealing with the following questions:

(a) Recognizing that the purposes of defining a base for income taxation and of measuring net income for published financial statements do differ, to what extent, if at all, is it necessary or desirable for taxable income to differ from accounting net income?

(b) If such differences appear, to what extent should income tax practice be recognized in determining net income for financial accounting purposes?

(c) Should financial accounting procedures or reporting methods ever be decreed by Congressional statute?

6. The Committee's conclusions on these questions are as follows:

(a) The right of Congress to grant tax concessions as a matter of legislative policy, or to impose economic or social disciplines, or to deny deductions for the purpose of generating revenues, is unquestioned. However, neither the Congress nor the administrative authorities nor the Courts should undertake to modify the application of generally accepted accounting principles, consistently used by the taxpayer for published statement purposes, solely to alter the timing of recognition of income or expense for tax purposes.

(b) Corporate accounting practices for purposes of published financial statements should be governed wholly by generally accepted accounting principles, irrespective of measurements of taxable income under provisions of the tax laws.

(c) Accounting principles should not be formulated or public reporting methods prescribed by directives of the tax laws; the body of accounting principles and the methods of reporting should evolve from the needs and uses of the broad public interest.

Discussion

7. Since the enactment in 1913 of the first revenue act under the Sixteenth Amendment, there has been a notable and unfortunate lag in the legal appreciation of accounting principles. This was responsible for the failure to recognize the accrual concept in the early tax laws. The 1913 income tax law was largely one which, by its terms, assessed a tax against cash income. Because of the problems of interpretation of such a statute and the inequities inherent in it, the regulations and the laws in later years have given general recognition to the accrual principle.

8. The revenue acts in force from 1913 to the present time have all provided for recognition of the method of accounting employed by the taxpayer. [See §446(a) and (b), providing that taxable income "shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books," but that "if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income."]

9. Despite this promulgation, there has developed a widening gap between

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* Section 472(c) provides that a taxpayer may use the LIFO method of valuing inventories only if no other method is used in reports to stockholders or partners and creditors. — Ed.

accounting net income and taxable income. The factors which have caused these variations are:

(a) Congressional enactments granting concessions (either by exclusions of income or allowances of special deductions from income), or imposing limitations or penalties for purposes of economic or social discipline or to protect the revenues. Examples are (1) the exemption of proceeds of life insurance policies, (2) the granting of percentage depletion allowances, (3) the denial of deductions for compensation paid in violation of wage stabilization laws, and (4) the limitations of deductions for contributions to charity.

(b) Legalistic interpretations of the tax statutes by administrative or Court decisions seemingly influenced largely by considerations of cash flow, in violation of the accrual principle of accounting. These are in the form of differences of timing of the recognition of income or deductions, examples of which are (1) the taxability of prepayments for services which are expected to be rendered in the future, and (2) the denial of deductions for accruals for known liabilities of indefinite amount.

10. The tax laws are designed to effectuate a special purpose — the raising of revenue. It is wholly within the rights of Congress to prescribe its definition of taxable income and, in so doing, to specify additions to or deductions from accounting net income as it sees fit. The allowance of percentage depletion, the exemption of certain reorganizations and like-kind exchanges, the denial of deductions for interest paid to carry tax-exempt securities or to purchase single premium life insurance policies, and other similar provisions, all recognize social, economic, and political considerations without containing any suggestions that they modify business accounting concepts.

11. With such specific and intended exceptions, however, the Committee believes that the public interest will best be served if the differences between taxable income and business income are reduced, and if the general mandate of [§446(a)] is permitted to take precedence over non-accounting interpretations of the individual provisions of the law. The principal differences of this character involve matters of timing of the recognition of income or deductions, ignoring consistent methods of accounting used by the taxpayer or recognized as general practices. The Committee believes that, unless an important overriding consideration dictates a modifying legislative provision of the type described in paragraph 9(a), the interests of government, business, and the public, would best be served if the definition of business income subject to tax were made as nearly as possible coincidental with net income under generally accepted accounting principles; it therefore supports the view that differences of the type described in paragraph 9(b) should be eliminated by administrative regulation or, if necessary by legislation.

12. The tax laws have unduly and unintentionally tended to influence the development of corporate accounting in that to some extent legislative concessions in measuring taxable income have been adopted into accounting practice without justification in principle. An illustration of this is the installment basis of reporting income [§453, permitting the taxpayer to elect to recognize the gain realized on certain installment sales as the payments are received, rather than reporting the full amount of the gain in the year of the sale, infra p. 813]. There is no sound accounting reason for the use of the installment method for financial statement purposes in the case of closed transactions in which collection is dependent upon lapse of time and the probabilities of realization are properly evaluated.[1]

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[1] On this point, see Supplementary Statement No. 1, issued December 31, 1950. Many accountants, including some members of this Committee, believe that methods consistently applied which accomplish a full matching of costs with revenue do not violate the accrual principle even though recognition is deferred until collection. However, if collection is reasonably assured, such a delay in recognition is not, in the opinion of the Committee, the best practice. Furthermore, where such methods are employed, disclosure is usually incomplete. In any event, the so-called

In the opinion of the Committee, such income has accrued and should be recognized in financial statements, even though deferred for tax purposes. Another example is the practice common during World War II of reflecting amortization of "emergency facilities" in financial statements in amounts corresponding to allowable tax deductions [see §168], even though in some cases the expected useful life of the facilities was longer than the statutory sixty months.

13. In one notable respect, Congress has undertaken specifically to influence accounting practices by legislation, in that the law conditions the use of the LIFO (last-in first-out) method of inventory pricing upon a requirement that the valuation so determined be used for the purpose of reports or statements to shareholders, partners, or proprietors and for credit purposes. This requirement [§472(c)] is an unwarranted and unnecessary encroachment and, in the opinion of the Committee, should be eliminated by legislation.

NOTE

1. *Statutory standards for timing of income and deductions.* After concluding that "social. economic and political considerations" may properly lead Congress to allow percentage depletion, deny the deduction of interest paid to purchase tax-exempt securities, etc., does the American Accounting Association imply that Congress should *never* "alter the timing of recognition of income or expense for tax purposes" (paragraph 6(a) supra)? Does the statement imply that §453 (installment method), §165(h) (certain disaster losses may be deducted in taxable year prior to occurrence), and §165(e) (theft losses deductible in year of discovery) ought to be repealed?

Is there any justification for permitting an item to be treated in a special way for tax purposes only if (as in the case of §472(c), criticized by the Association) it is treated by the taxpayer in the same way in its published financial statements?

2. *Differences between tax accounting and business accounting.* An extensive list of the places where tax accounting and business accounting part company may be found in Reimer, Major Differences Between Net Income for Accounting Purposes and for Federal Income Taxes, 23 Accounting Rev. 305 (1948). Smith and Butters, in Taxable and Business Income (1949), report on a comparison of "book profit" as reported by a number of corporations in their public reports to the Securities and Exchange Commission and the "statutory net income" as computed by the same corporations for tax purposes. For the companies studied, book profit typically exceeded statutory net income by less than 10 per cent, and this difference was more or less wiped out by upward adjustments of statutory net income by the Internal Revenue Service on its audit of the tax returns. For some industries, however, the difference was typically much greater, and this was especially so for mining and public utility corporations, where there are substantial differences in the treatment of depletion and depreciation in computing book profit and statutory net income. Moreover, for individual companies there were also significant divergencies between book profit and statutory net income, though a difference in one direction in one year would sometimes be offset by a difference in another direction in a later year.

3. *1954 provisions to reconcile tax accounting with business accounting.* The 1954 Code contained several provisions "designed to bring the income-tax provisions of the law into harmony with generally accepted accounting principles" (S. Rept. 62). Although widely acclaimed for this reason when enacted, these provisions (§§452 and 462) were repealed in 1955. Infra page 805.

4. *References.* Hahn, Methods of Accounting: Their Role in the Federal Income Tax Law, 1960 Wash. U.L.Q. 1; Cannon, Tax Pressures on Accounting Principles and Accountants' Independence, 27 Accounting Rev. 419 (1952); Lasser and Peloubet, Tax Accounting v. Commercial Accounting, 4 Tax L. Rev. 343 (1949); Werntz, The Influence of Changing Tax Rates on Accounting and Auditing Procedures, 28 Taxes 658 (1950); Caldwell, Rela-

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installment sales method as usually applied does not secure an adequate matching of revenues and costs.

tionship Between Tax Accounting and the Requirements of Other Government Agencies, 11 N.Y.U. Inst. on Fed. Taxation 207 (1953).

2. *The Cash Receipts and Disbursements Method*

BLATTMACHR, KNAPP, and WARREN, ACCOUNTING PERIODS AND ACCOUNTING METHODS *

30-32 (1952)

Historically, as well as under the Code, the fundamental method of reporting income is on a cash receipts and disbursements basis. Generally speaking, taxpayers using this method report items of income and deductions in the year when actually received or paid. No account is taken of bills rendered or received. Items of income earned by or due to the taxpayer are not included until actually *received*, and expenses incurred or payable are not deducted until actually *paid*. The relative simplicity of the application and use of this method makes it the choice of the large body of individual taxpayers who are salaried or professional people. Since billings need not be taken into account, the cash method usually does not require books of account or at most, requires the use of a very elementary system of bookkeeping. Where the taxpayer does not keep books, the courts have held that income must be reported on the cash basis. . . .

Although the cash method ordinarily implies the receipt of income or the payment of a deductible item, it is not limited to the actual receipt or payment of *cash* by the taxpayer. Receipt or payment may be in the form of equivalents of cash. Thus, income is realized when the taxpayer receives it regardless of its form, whether in cash, property or other benefits measurable in money's worth. The amount received is determined by the arm's-length stipulated value or the market value at the time received.

Regardless of the form of payment, income results and a payment is made at the time when it is received or paid out and the controlling point of time is not when the equivalent of cash is later converted into cash money. Thus, where an employee receives corporate stock as compensation, he has obtained income to the extent of the fair market value of the stock at the time he receives the shares of stock; the receipt of taxable income is not regarded as being delayed until he sells the stock for cash. Similarly, taxable income is received when the note or check is received and not when the instrument is negotiated for money. . . .

In order to constitute income, however, it is not necessary that payment be made directly to the taxpayer. A taxpayer may be considered as having received the benefit of a payment made to a third party. Thus, an employee may receive compensation for his services at the time his income taxes, the premiums on his insurance policy, or his debts are paid by his employer. So, too, a landlord will be held to have received additional rent in the year that his taxes or his mortgage payments are discharged by the tenant. . . .

AMEND v. COMMISSIONER

13 T.C. 178 (1949)

BLACK, Judge: We have two taxable years before us for decision, 1944 and 1946. . . .

In each of the taxable years there is one common issue and that is whether the doctrine of constructive receipt should be applied to certain payments which

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petitioner received from the sale of his wheat. There is no controversy as to the amounts which petitioner received or as to the time when he actually received them. Petitioners, being on the cash basis, returned these amounts as part of their gross income in the years when petitioner actually received them. . . .

In applying the doctrine of constructive receipt, the Commissioner relies upon Regulations 118, section 39.42-2, printed in the margin.[1]

In Loose v. United States, 74 Fed.(2d) 147, the rule providing for the taxation of income constructively received is stated as follows:

> . . . the strongest reason for holding constructive receipt of income to be within the statute is that for taxation purposes income is received or realized when it is made subject to the will and control of the taxpayer and can be, except for his own action or inaction, reduced to actual possession. So viewed, it makes no difference why the taxpayer did not reduce to actual possession. The matter is in no wise dependent upon what he does or upon what he fails to do. It depends solely upon the existence of a situation where the income is fully available to him. . . .

Respondent, in his brief, relies upon the *Loose* case, from which the above quotation is taken, and several other cases which deal with the doctrine of constructive receipt. Needless to say, each of those cases depends upon its own facts. In the *Loose* case, for example, interest coupons had matured prior to the decedent's death. The decedent had not presented them for payment because of his physical condition. It was held that, even though the decedent had not cashed them, the interest coupons represented income to him in the year when they matured, under the doctrine of constructive receipt.

It seems clear to us that the facts in the instant case do not bring it within the doctrine of *Loose* v. *United States, supra,* and the other cases cited by respondent dealing with constructive receipt.

In discussing the situation which we have in the instant case, we turn our attention first to the contract of sale which petitioner made of his 1944 wheat crop to Burrus. The testimony was that 1944 was a bumper wheat crop year and that petitioner produced and harvested about 30,000 bushels, some of which was lying out on the ground and some of which was stored on the farm. Petitioner, through his attorney in fact, Paul Higgs, sold this wheat to Burrus for January 1945 delivery at $1.57 per bushel. It was the understanding that petitioner would ship his wheat to Burrus at once and that Burrus would pay him for it in January of the following year. The contract was carried out. Some time during the month of August 1944, after August 2, petitioner shipped the 30,000 bushels to Burrus. Burrus received it, put it in its elevator, and paid petitioner for it by check dated Janary 17, 1945.

Respondent's contention seems to be based primarily on the fact that petitioner could have sold Burrus the wheat at the same price for immediate cash payment in August 1944 and that although he did not do so, he should be treated in the same manner as if he had and the doctrine of constructive receipt should be ap-

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[1] Sec. 39.42-2. Income Not Reduced to Possession. Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited or set apart to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made, and must be made available to him so that it may be drawn at any time, and its receipt brought within his own control and disposition.

[The comparable provision of the current Regulations is Regs. §1.451-2: Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account or set apart for him so that he may draw upon it at any time. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. — Ed.]

plied to the payments received. We do not think the doctrine of constructive receipt goes that far. Porter Holmes, who was the manager of the Burrus Panhandle Elevator in Amarillo at the time of the 1944 transaction, testified at the hearing. He testified that it was the usual custom of Burrus to pay cash for wheat soon after it was delivered and that the transaction between Burrus and petitioner for January 1945 delivery and settlement was unusual and that he telephoned the manager at Dallas, Texas, for authority to make the deal that way and secured such authority and the deal was made. He testified that when Burrus' check for $40,164.08 was mailed to petitioner January 17, 1945, it was done in pursuance of the contract. So far as we can see from the evidence, petitioner had no legal right to demand and receive his money from the sale of his 1944 wheat until in January 1945. Both petitioner and Burrus understood that to be the contract. Such is the substance of the testimony of both petitioner, who was the seller of the wheat, and Holmes, who acted for the buyer. Such also is the testimony of Paul Higgs, who represented the seller in the negotiations for the sale. During 1944 all that petitioner had in the way of a promise to pay was Burrus' oral promise to pay him for the wheat in January 1945. Burrus was a well known and responsible grain dealer and petitioner testified that he had not the slightest doubt that he would receive his money in January 1945, as had been agreed upon in the contract. Such a situation, however, does not bring into play the doctrine of constructive receipt. See Bedell v. Commissioner, 30 Fed.(2d) 622, wherein the court said:

> While, therefore, we do not think that the case is like a promise to pay in the future for a title which passes at the time of contract, we would not be understood as holding by implication that even in that case the profit is to be reckoned as of the time of sale. If a company sells out its plant for a negotiable bond issue payable in the future, the profit may be determined by the present market value of the bonds. But if land or a chattel is sold, and title passes merely upon a promise to pay money at some future date, to speak of the promise as property exchanged for the title appears to us a strained use of language, when calculating profits under the income tax. . . . it is absurd to speak of a promise to pay in the future as having a "market value," fair or unfair. . . .

The doctrine that a cash basis taxpayer can not be deemed to have realized income at the time a promise to pay in the future is made was reiterated by the Circuit Court of Appeals for the Eighth Circuit in the more recent case of Perry v. Commissioner, 152 Fed.(2d) 183. In that case it was stated:

> These cases seem to be predicated upon the fact that in a contract of sale of property containing a promise to pay in the future, but not accompanied by notes or other unqualified obligations to pay a definite sum on a day certain, the obligation to pay and the obligation to pass title both being in the future, there is an element of uncertainty in the transaction and the promise has no "market value," fair or unfair. This theory is supported by the decision of the Supreme Court in Lucas v. North Texas Co. . . .

The Commissioner in the instant case is not contending that Burrus' contract to pay petitioner for his wheat in January 1945 had a fair market value equal to the agreed purchase price of the wheat when the contract was made in August 1944. What he is contending is that petitioner had the unqualified right to receive his money for the wheat in 1944; that all he had to do to receive his money was to ask for it; and that, therefore, the doctrine of constructive receipt applies as defined in section 39.42-2, Regulations 118.

For reasons already stated, we do not think the Commissioner's determination to this effect can be sustained. If petitioner had begun this method of selling his wheat in 1944, when he had a bumper crop, there might be reason to doubt the bona fides of the contract, but what we have said about the 1944 transaction between Burrus and petitioner is based upon the finding that the contract between

Burrus and petitioner was bona fide in all respects, though it was initiated by petitioner, and each party was equally bound by its terms. Petitioner did not begin this method of selling his wheat in 1944 — he began it in 1942 and continued it through 1946. No doubt his taxes were more in some years and less in others than they would have been if petitioner had sold and delivered his wheat for cash in the year when it was produced. To illustrate this we need only point out that under the method which petitioner used he reported income in 1945 upon which he paid a tax of $2,672.64. His wife Eva also reported income and paid a tax of about the same amount. By treating petitioner's proceeds from the sale of his 1944 wheat as constructively received in 1944, the Commissioner determined overassessments as to each petitioner for 1945 and deficiencies against each petitioner for 1944.

Petitioner was asked at the hearing why he adopted the manner of selling his wheat which has been detailed in our findings of fact. His answer was as follows:

> Well, that had been my practice, to handle that wheat that way since 1942 and I have handled my wheat that way, '42, '43, '44, '45, '46, '47 and into 1948. It is still my practice to do that and there have been some years in the interval that I would certainly have paid less income had I handled it the other way, but that is a semi-arid country and we are uncertain about our wheat crops and our expenses are always pretty well set and we know they are going to be high and we need for own protection to carry part of this wheat forward. . . .
>
> As I have already explained, it's been a matter of making my income more uniform and even: about five of those years had it all been set back and sold in the year that it was supposed to have been sold in, my income tax would have been less and in the other two it would have been more. I merely emphasize that to show the consistency of my policy and not as a matter of paying any tax.

Whether the reasons advanced by petitioner in his testimony quoted above are good or bad as a business policy, we do not undertake to decide. The question we think we have to decide is whether the contracts detailed in our findings of fact were bona fide arm's-length transactions and whether under them the petitioner had the unqualified right to receive the money for his wheat in the year when the contracts were made and whether petitioner's failure to receive his money was of his own volition. Our conclusion, as already stated, is that the contracts were bona fide arm's-length transactions and petitioner did not have the right to demand the money for his wheat until in January of the year following its sale. This being true, we do not think the doctrine of constructive receipt applies. See Howard Veit, first point decided, 8 T.C. 809.

Petitioner, in each of the years before us, returned as a part of his gross income the checks which he actually received in payment for his wheat. This being so, we think he complied with the income tax laws governing a taxpayer who keeps his accounts and makes his returns on the cash basis.

We have discusseed in detail above only the sale which petitioner made of his wheat to Burrus in August 1944. The sale of his 1945 and 1946 wheat was made to Coffee-Davis Grain Co. under substantially the same circumstances as the sale to Burrus and it need not be separately discussed. . . .

NOTE

1. *Arrangements to postpone realization of income.* What if the taxpayer had received a promissory note, due the following year, when he delivered the grain to the buyer? Would it make a difference whether the note was received as evidence of the debt, or as payment? See Williams v. Commissioner, 28 T.C. 1000 (1957).

Would the result in the case have been different if the taxpayer had sold the wheat on

credit, payment to be on demand, and had refrained from demanding payment until it suited him to do so? What if an attorney, after completing the performance of services for a client, refrains from billing the client in order to postpone the recognition of income until a later year?

Can an employee arrange with his employer to have his compensation paid in installments over a period of time, including the period after retirement when he presumably will be in lower tax brackets? For discussion of a variety of arrangements to accomplish this objective, see Rev. Rul. 60-31, 1960-1 C.B. 174. The business result of one such plan was described as follows by Time (Jan. 19, 1959, p. 66):

> For appearing in Bridge on the River Kwai, William Holden agreed to 10% of the gross, but for tax reasons wanted it paid to him at the rate of only $50,000 a year. The picture has already made so much money (between $20 and $30 million) that Holden's share now stands at between $2,000,000 and $3,000,000. Not only will it take 40-year-old Holden at least 40 years to get the last of his money, but Columbia can in the meantime invest it and make well over $50,000 a year, thus in effect having got Holden's services in Kwai for nothing.

Does a taxpayer constructively receive an amount he refuses to receive? Hedrick v. Commissioner, 154 F.2d 90 (2d Cir. 1946); Commissioner v. Giannini, 129 F.2d 638 (9th Cir. 1942); G.C.M. 27026, supra page 344; Tritt, Renunciation — Income Tax Problems, 1953 So. Calif. Tax Inst. 519. See also §678(d).

For the possibility of amending an existing contract to postpone the receipt of taxable income, see Commissioner v. Olmsted Inc. Life Agency, supra page 442, and Commissioner v. Oates, summarized in the *Olmsted* case.

2. *"Substantial limitations or restrictions."* As formulated in the current Regulations, the doctrine of constructive receipt is not applicable if the taxpayer's control of the income "is subject to substantial limitations or restrictions." If the taxpayer is entitled to receive interest at the rate of 4 per cent per year on a deposit in a savings bank or savings and loan association, but will receive a "bonus" of ½ per cent if he leaves his funds on deposit for five years, does he constructively receive the 4 per cent that is currently credited to his account? See Regs. §1.451-2 (promulgated in 1964); Snider's Estate v. Commissioner, 31 T.C. 1064 (1959) (cash surrender value of annuity policy not constructively received in view of insurer's power to postpone payment for six months, nor was doctrine of constructive receipt made applicable by insured's election to leave principal sum on deposit under installment option); see also Snider's Estate v. Commissioner, 39 T.C. 341 (1962) (later installment of same dispute; held, principal sum not constructively received when insurer's option to postpone payment for six months expired).

For the effect of escrow arrangements, see Dyke v. Commissioner, supra page 585, and authorities cited in the editor's note thereafter; Anderson v. Commissioner, ¶61,139 P-H Memo T.C. (1961).

See also Carpenter v. Commissioner, 34 T.C. 408 (1960) (part of sales proceeds for taxpayer's stock withheld by buyer, pursuant to supplemental agreement, pending settlement of lawsuits challenging her title; held, not constructively received).

3. *Doctrine of constructive receipt invoked by taxpayer.* Ross v. Commissioner, 169 F.2d 483 (1st Cir. 1948), held that a taxpayer could rely on the doctrine of constructive receipt to defeat the Commissioner's assertion of a deficiency for the year of actual payment, although the amounts in question had not been reported by him in the earlier years, which were now barred by the statute of limitations. The amounts in question (accrued salary) had been credited to the taxpayer on the books of his employer, which was on the accrual basis, and deducted by it. The court held that the taxpayer was not estopped or otherwise barred by equitable considerations, partly because there was no misrepresentation of the facts:

> . . . [T]he discrepancy between the individual returns and the corporate return was always evident, whether or not it registered on the official consciousness. . . . A mere failure to report income is not a representation that such income has in fact not been received. Inasmuch as the tax incidence of so many transactions is as doubtful as it is, from the mere failure to report income no more significant inference should be

drawn than the taxpayer's own interpretation of the law. And it seems settled that estoppel cannot be predicated upon a mere statement of law or silence resulting from an error of law. [169 F.2d at 495-496.]

See page 877 infra on the possibility of opening up the earlier years, notwithstanding the running of the statute of limitations, because of the taxpayer's inconsistent position.

4. *References.* Comment, Constructive Receipt: When Must the Taxpayer Pay? 45 Ill. L. Rev. 77 (1950); Note, Checks and Notes as Income When Received by a Cash-Basis Taxpayer, 73 Harv. L. Rev. 1199 (1960); Rice, The New Tax Policy on Deferred Compensation, 59 Mich. L. Rev. 381 (1961; Irell and Stone, Current Developments in Deferred Compensation: Arrangements for the Individual Employee, 1961 So. Calif. Tax Inst. 325; Eisenstein, A Case of Deferred Compensation, 4 Tax L. Rev. 391 (1949); Freyburger, Constructive Receipt of Income: Settlements Under Life Insurance Contracts, 30 Taxes 867 (1952); Gemmill, Deferral of Compensation Frequently Results in Overall Economic Loss, 19 J. Taxation 276 (1963).

COMMISSIONER v. BOYLSTON MARKET ASSN.

131 F.2d 966 (1st Cir. 1942)

Before MAGRUDER, MAHONEY, and WOODBURY, Circuit Judges.

MAHONEY, Circuit Judge.

The Board of Tax Appeals reversed a determination by the Commissioner of Internal Revenue of deficiencies in the Boylston Market Association's income tax of $835.45 for the year 1936, and $431.84 for the year 1938, and the Commissioner has appealed.

The taxpayer in the course of its business, which is the management of real estate owned by it, purchased from time to time fire and other insurance policies covering periods of three or more years. It keeps its books and makes its returns on a cash receipts and disbursements basis. The taxpayer has since 1915 deducted each year as insurance expenses the amount of insurance premiums applicable to carrying insurance for that year regardless of the year in which the premium was actually paid. This method was required by the Treasury Department prior to 1938 by G.C.M. 13148, XIII-1 Cum. Bull. 67 (1934). Prior to January 1, 1936, the taxpayer had prepaid insurance premiums in the amount of $6,690.75 and during that year it paid premiums in an amount of $1082.77. The amount of insurance premiums prorated by the taxpayer in 1936 was $4421.76. Prior to January 1, 1938, it had prepaid insurance premiums in the amount of $6148.42 and during that year paid premiums in the amount of $890.47. The taxpayer took a deduction of $3284.25, which was the amount prorated for the year 1938. The Commissioner in his notice of deficiency for the year 1936 allowed only $1082.77 and for the year 1938 only $890.47, being the amounts actually paid in those years, on the basis that deductions for insurance expense of a taxpayer on the cash receipts and disbursements basis is limited to premiums paid during the taxable year.

We are asked to determine whether a taxpayer who keeps his books and files his returns on a cash basis is limited to the deduction of the insurance premiums actually paid in any year or whether he should deduct for each tax year the pro rata portion of the prepaid insurance applicable to that year. . . .

This court in Welch v. DeBlois, 1 Cir., 1938, 94 F.2d 842, held that a taxpayer on the cash receipts and disbursements basis who made prepayments of insurance premiums was entitled to take a full deduction for these payments as ordinary and necessary business expenses in the year in which payment was made despite the fact that the insurance covered a three-year period. The government on the basis of that decision changed its earlier G.C.M. rule, supra, which had required the taxpayer to prorate prepaid insurance premiums. The Board of Tax Appeals

has refused to follow that case in George S. Jephson v. Com'r, 37 B.T.A. 117; Frank Real Estate & Investment Co., ¶39,499 P-H Memo T.C. and in the instant case. The arguments in that case in favor of treating prepaid insurance as an ordinary and necessary business expense are persuasive. We are, nevertheless, unable to find a real basis for distinguishing between prepayment of rentals . . . ; bonuses for the acquisition of leases . . . ; commissions for negotiating leases . . . ; and prepaid insurance. Some distinctions may be drawn in the cases [citations omitted] on the basis of the facts contained therein, but we are of the opinion that there is no justification for treating them differently insofar as deductions are concerned. All of the cases cited are readily distinguishable from such a clear cut case as a permanent improvement to a building. This latter is clearly a capital expenditure. See Parkersburg Iron & Steel Co. v. Burnet, 4 Cir., 1931, 48 F.2d 163, 165. In such a case there is the creation of a capital asset which has a life extending beyond the taxable year and which depreciates over a period of years. The taxpayer regardless of his method of accounting can only take deductions for depreciation over the life of the asset. Advance rentals, payments of bonuses for acquisition and cancellation of leases, and commissions for negotiating leases are all matters which the taxpayer amortizes over the life of the lease. Whether we consider these payments to be the cost of the exhaustible asset, as in the case of advance rentals, or the cost of acquiring the asset, as in the case of bonuses, the payments are prorated primarily because the life of the asset extends beyond the taxable year. To permit the taxpayer to take a full deduction in the year of payment would distort his income. Prepaid insurance presents the same problem and should be solved in the same way. Prepaid insurance for a period of three years may be easily allocated. It is protection for the entire period and the taxpayer may, if he desires, at any time surrender the insurance policy. It thus is clearly an asset having a longer life than a single taxable year.* The line to be drawn between capital expenditures and ordinary and necessary business expenses is not always an easy one, but we are satisfied that in treating prepaid insurance as a capital expense we are obtaining some degree of consistency in these matters. We are, therefore, of the opinion that Welch v. DeBlois, supra, is incorrect and should be overruled.

The decision of Board of Tax Appeals is affirmed.

NOTE

1. *Implications of the Boylston Market case.* In Waldheim Realty & Investment Co. v. Commissioner, 245 F.2d 823 (8th Cir. 1957), the court rejected the *Boylston Market* theory and held that a cash basis taxpayer may deduct the insurance premiums when paid, but also suggested that the taxpayer might allocate them if he preferred to do so.

In Fackler v. Commissioner, 39 B.T.A. 395, 398 (1939), a taxpayer was allowed to deduct prepaid interest on a mortgage in the year of payment. The court said:

> . . . distortion of the petitioner's income would not result here from the deduction of this prepaid interest payment any more than it would from the payment in one of the current taxable years for interest covering an elapsed period of more than those years.

The *Fackler* case has been accepted by the Service, I.T. 3740, 1945 C.B. 109, and its principle is also applied to the prepayment of taxes, Glassell v. Commissioner, 12 T.C. 232 (1949). Note that §§163 and 164 allow the deduction of taxes and interest "paid or ac-

* See Regs. §1.461-1(a)(1): "If an expenditure [by a cash basis taxpayer] results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made" — Ed.

crued within the taxable year." Section 162(a) allows "ordinary and necessary expenses paid or incurred during the taxable year" to be deducted. Do these sections justify the deduction of taxes and interest by a cash basis taxpayer in whatever year he pays them, but require expenses to be deducted only in the year in which they constitute *expenses*, as distinguished from *capital investments*?

If the taxpayer in the *Boylston Market* case had purchased and paid for a three-year stock of materials or supplies, it might have been required to inventory them, thus restricting the deduction for the current year to the amount actually consumed then, if this procedure was necessary to prevent a distortion of income. See Regs. §1.162-3. Cash basis farmers sometimes engage in the practice (the converse of the arrangement described in *Amend*, supra p. 780) of paying suppliers of feed, fertilizer, etc. for goods to be delivered in future years. On their right to deduct the payments when made, see Cravens v. Commissioner, 30 T.C. 903 (1958) (held, payment was a deposit, not a deductible expense); Ernst v. Commissioner, 32 T.C. 181 (1959) (contra). See Irwin, Prepayments by a Cash Basis Taxpayer, 1963 So. Calif. Tax Inst. 547.

2. *Postponing payment for tax reasons.* If the taxpayer in the *Boylston Market* case had paid the total premium at the end of the three-year period, could he have deducted the full amount in that year? Is there any restriction on the right of a cash basis taxpayer to postpone payments in order to take deductions in advantageous years?

3. *Use of checks and notes by cash basis taxpayers.* It has been held that the cash basis taxpayer does not get a deduction when he gives his note for a deductible expense, even if the note is taken as payment of the debt. Helvering v. Price, 309 U.S. 409 (1940). On the other hand, the giving of a check fixes the time of deduction if the check is subsequently honored. See Estate of Spiegel v. Commissioner, 12 T.C. 524 (1949); although directly concerned with the meaning of "payment" under §170, the opinion seems equally applicable to other deductions by cash basis taxpayers.

4. *"Constructive payment"?* A corporate taxpayer on the cash basis credited its two principal officers and stockholders with compensation for services under circumstances requiring them to report the salaries as constructively received. In Vander Poel, Francis & Co., Inc. v. Commissioner, 8 T.C. 407 (1947), a divided court held that the salaries could not be deducted by the employer until paid by it; the court refused to accept a doctrine of "constructive payment" as a corollary to constructive receipt.

5. *Cash method of accounting as failing to "clearly reflect income."* The taxpayer's method of accounting is not controlling if it "does not clearly reflect income," in which event the Treasury may prescribe another method under §446(b). For discussion of, and citation of authority on, the circumstances in which the cash method does not clearly reflect income, see Drazen v. Commissioner, 34 T.C. 1070 (1960).

To the effect that the theoretical clarity of the cash method "has been dissipated by accountants careless of pen, lawyers chary of accounting, and commissioners careful of revenue," that there is both a "pure" and an "impure" cash method, and that only the latter may be lawfully used, see Hahn, Methods of Accounting: Their Role in the Federal Income Tax Law, 1960 Wash. L.Q. 1.

3. *Accrual Methods*

GEORGIA SCHOOL-BOOK DEPOSITORY, INC. v. COMMISSIONER
1 T.C. 463 (1943)

KERN, Judge: The question is whether petitioner, which was on an accrual basis, should have accrued certain school book commissions at the time the books were sold by the publishers to the state, or should have returned them as income only when the books were paid for by the state, as petitioner contends.

Petitioner was a broker which received an 8 per cent commission on all school books purchased by the State of Georgia through it. For this commission it performed certain services of advantage to both parties, such as executing the contracts of the state board of education with various publishers, taking care of the

books as a central depository until final distribution, seeing that enough were on hand to meet the state's demands, distributing them, and collecting the moneys in payment from the state and holding them in trust until paid over to the publishers. It was responsible for the return in salable condition of any books not used. It had no title to the books at any time, and (except in the case of one publisher) posted a bond with each publisher to guarantee performance of its duties. Petitioner also carried on a somewhat similar business as a book broker of college books not on the state list and under these contracts was responsible for the collection of all accounts.

Petitioner did not accrue its commissions on the state books but did accrue its commissions on the college books at the same time that its liability for the books to the publishers was accrued. Under the contracts for state school books it was provided that petitioner should receive its brokerage "at the time of settlement" and this term is explained by the provision that the petitioner shall make quarterly reports "so as to show the exact balance due" the publisher by the petitioner, and shall remit "its *pro rata share* of all cash received from the collection of warrants issued by the State of Georgia for books sold to the state when and as such warrants are received."

The publishers could look for payment from the state, and, consequently, petitioner could look for its commissions only from the "Free Textbook Fund," which was renewed only from the excise laid on beer.* During the taxable years 1938 and 1939 this fund was insufficient to pay the petitioner in full. The state, in its accounting, did not treat these large deficits as present liabilities except to the extent that funds were already on hand to meet them, the remainder being considered an encumbrance on the textbook fund in the next year. The "accounts ripen," the auditor reported, "for payment when and as funds become available in the Textbook Fund."

Petitioner contends, first, that the brokerage was not earned until payment, and, secondly, that there was no reasonable expectancy that payment ever would be made; and for these reasons, it urges its ultimate contention that the commissions here involved were not properly accruable in the respective taxable years.

In so far as appears, all acts which were required of petitioner to earn its brokerage, save one, had been done in the taxable year. It had received the books from the publishers, stored them, and later distributed them to the several schools. All it had not done was to receive the money from the state and pay it out to the publishers. On this account the actual payment of the brokerage may not have been due to petitioner until this money was received, but the right to it had accrued by the performance of its duties. United States v. Anderson, 269 U.S. 422. It is the *right* to receive money which in accrual accounting justifies the accrual of money receivable and its return as accrued income.

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* The court's findings of fact describe the textbook fund as follows:

"On March 4, 1937, the State of Georgia enacted a Free Textbook Act, under which the state board of education was directed to inaugurate and administer a system of free textbooks for the public schools of Georgia, and to execute contracts therefor. The act provides that the cost of administering the free textbook system and purchasing the books shall be paid by the state from such funds as may be provided by the General Assembly for that purpose, ... The Legislature thereupon created a free textbook fund, made up solely from excise taxes on the sale of malt beverages in the state. The act provides that funds derived from taxes on malt beverages shall be apportioned as follows: Not over 3 percent shall be paid to the revenue commission for enforcing the malt beverage act and 'the remainder shall be set aside and devoted for the support of the common schools of the state and used for the purpose of furnishing free textbooks to the children attending the common schools'; any excess to be used for other school purposes. . . ." — Ed.

The Supreme Court said in Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (p. 184):

> . . . Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the right to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. . . .

The receipt of the money from the state, the deduction of petitioner's commission, and the transmission of the balance to the publishers were the least of its duties and can not be made the criterion of the arisal of the right. Paragraph 9 of the contract assumes that the publisher's right to payment had arisen, for it requires that the quarterly reports which petitioner was to submit should "show the exact balance due the first party by the second party [petitioner] . . ."

. . .

We pass, then, to the second question, whether there was a reasonable expectancy that the claim would ever be paid. Where there is a contingency that may preclude ultimate payment, whether it be that the right itself is in litigation or that the debtor is insolvent, the right need not be accrued when it arises. This rule is founded on the old principle that equity will not require a suitor to do a needless thing. The taxpayer need not accrue a debt if later experience, available at the time that the question is adjudged, confirms a belief reasonably held at the time the debt was due, that it will never be paid. Corn Exchange Bank v. United States, 37 Fed.(2d) 34 (2d Cir.); H. Liebes & Co. v. Commissioner, 90 Fed.(2d) 932 (9th Cir.), and cases there cited at page 937. On the other hand, it must not be forgotten that the alleviating principle of "reasonable expectancy" is, after all, an exception, and the exception must not be allowed to swallow up the fundamental rule upon which it is engrafted requiring a taxpayer on the accrual basis to accrue his obligations, Spring City Foundry Co. v. Commissioner, supra. If this were so, the taxpayer might at his own will shift the receipt of income from one year to another as should suit his fancy. Cf. Clifton Manufacturing Co., 1 T.C. 71. To allow the exception there must be a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent or that the insolvency of his debtor makes it improbable. Postponement of payment without such accompanying doubts is not enough. . . .

Applying these principles to the instant case, we must conclude that, despite the condition of the treasury of the State of Georgia when the free schoolbook fund was inaugurated and for several years thereafter, there was no reasonable expectation that the sums owed by the state to petitioner's publishers and, consequently, the commissions to petitioner itself, would not ultimately be paid. It would naturally take a few years to establish in full working order a system of such magnitude, but a comparison of the two years before us shows that Georgia was gradually reducing its schoolbook obligations. Georgia is a state possessing great resources and a fine record of fiscal probity, and undoubtedly it can and will meet its obligations. The fact that petitioner, on behalf of its principals, continued to sell and deliver school books to the state indicates that there was no serious doubt as to the ultimate collection of the accounts here involved.

We conclude, therefore, that petitioner's commissions on all books purchased by the state through it in the taxable years should have been accrued and returned as income in those years.

Judgment will be entered for the respondent.

COMMISSIONER v. HANSEN

360 U.S. 446 (1959)

MR. JUSTICE WHITTAKER delivered the opinion of the Court.

These federal income tax cases present questions concerning the proper and timely accrual of gross income deriving from sales of commercial installment paper by retail dealers to finance companies. The taxpayers involved in these cases are two retail automobile dealers and a house trailer dealer. All keep their books on the accrual basis. Most of their sales are "credit sales." It appears that they generally negotiate, consummate, and finance such sales in accordance with a common pattern. The dealer and his customer agree upon a "Cash Delivered Price" for a particular vehicle owned by the dealer. In part payment of that price the customer makes a down payment to the dealer in cash or "trade in," or both. To the remaining balance of that cash price there is added the cost of insurance on the vehicle and a "finance charge." The aggregate is sometimes called the "Deferred Balance." It is evidenced and secured by an assignable or negotiable instrument retaining defeasible title to or a lien on the vehicle — generally on a form supplied by the finance company with which the dealer may then be doing business — and the instrument is signed by the customer, delivered to the dealer, and made payable to him in monthly installments over an agreed period — one to three years on automobiles and three to five years on house trailers. Thereupon, the dealer delivers the vehicle to his customer, with such memoranda or bill of sale as will enable him to register, license and use it.

Soon after completion of these procedures, these dealers sell (discount) those instruments (hereafter called "installment paper") to finance companies for an agreed or formula fixed price, and the dealers guarantee payment, in whole or in part, of the installment paper.

Under contracts between the respective dealers and finance companies here concerned, the latter, upon receipt and acceptance of installment paper, are obligated to pay immediately to the dealers a major percentage of the purchase price, but they are thereby also authorized to retain the remaining percentage of the price and to credit it on the books to a "Dealers Reserve Account" in the name of the particular dealer, for the purpose of securing performance by him of his guarantor, endorser, and other liabilities to the finance company.

The dealers involved in these cases recorded on their books in the years the installment paper was sold, and included in their income tax returns for those years, the cash received from the finance companies, but they did not accrue on their books or include in their returns the percentage of the price that was retained by the finance companies and credited to their reserve accounts.

The Commissioner contends that in the year of their sales of installment paper to the finance companies, the taxpayers acquired a *fixed right to receive* — even though not until a later year — the percentage of the purchase money that was retained by the finance companies and credited on their books to the dealers' reserve account in that year, and, hence, those amounts constituted accrued income to the taxpayers in that year, and should have been accrued on their books and included in their returns for that year. The taxpayers, on the other hand, contend that the amounts so retained and credited were never under or subject to their control, and were always subject to such contingent liabilities of the taxpayers to the finance companies that it could not have been known, in the year of the sales, how much, if any, of the reserves would actually be received by them in cash, and hence they did not acquire, in the year of any of the sales, a fixed

right to receive — in a later year or at any time — the amounts credited to them in the reserves, and, therefore, the reserves did not constitute accrued income to them. This presents, in essence, the issue for decision in these cases. . . .

We turn, first, to the taxpayers' contention that, in substance, the purchaser, not the dealer, obtains the loan directly from a finance company, and that the percentage of the loan which is retained by the finance company — although credited on its books to a reserve account in the name of the dealer as collateral security for the payment of his liabilities to the finance company — is the property of the purchaser of the vehicle, not the dealer, and therefore may not be regarded as accrued income to the dealer.

The basis of the contention (filling in the omitted but necessarily involved steps) is that each of these transactions is a single, "three-cornered" one between the dealer, the finance company and the purchaser; that, in substance, the dealer agrees to sell the vehicle to the purchaser for "a down payment plus cash" (the term "cash" as here used must necessarily refer to the unpaid balance of the purchase price); that the purchaser agrees immediately to obtain from the finance company, and it agrees to make to the purchaser, a loan, on the security of the vehicle, in an amount at least equal to the unpaid balance of the purchase price owing by the purchaser to the dealer for the vehicle; and that the purchaser agrees immediately to pay, or to direct the finance company to pay, to the dealer, out of the proceeds of the loan, an amount equal to 95% (in most instances) of the unpaid balance of the purchase price owing by the purchaser to the dealer for the vehicle. Although this leaves an unpaid balance of the purchase price of the vehicle (5% in most instances) still owing by the purchaser to the dealer, it also leaves in possession of the finance company, out of the proceeds of the loan, an amount at least equal to that 5%. Nevertheless the purchaser, with the consent of the dealer, agrees with the finance company that the latter shall retain that 5% and credit it on its books to a reserve account in the name of the dealer, as collateral security for the payment of his contingent liabilities to the finance company. On these assumptions of fact the taxpayers contend that the reserves retained by the finance companies, though credited on their books to the dealers' reserve accounts, are only contingently so credited and are subject to cancellation if the purchaser fails to pay out his loan and, at all events, the reserves belong to the purchasers, and should not be regarded as accrued income of the dealers. . . .

We agree, of course, that the incidence of taxation depends upon the substance, not the form, of the transaction . . . but we think that the taxpayers have assumed facts which are contrary to the records and are wholly without substance.

These records clearly show that, in every instance, the installment paper was executed by the purchaser and made payable to the dealer . . . and that the same was later assigned or endorsed by the dealer and sent to the finance company for purchase, under and subject to the dealer's contractually assumed contingent liabilities to the finance company respecting it, and that, every instance, the finance company, upon receipt and acceptance of the installment paper and of the dealer's obligations respecting it, immediately paid to the dealer a major percentage of the agreed or formula fixed price for the paper; but, pursuant to the terms of the dealer's contract with the finance company, the latter retained the remaining percentage of the price and credited it on its books to the dealer's reserve account, as collateral security for the payment of his contingent liabilities to the finance company on such installment paper.

It is therefore clear that the retained percentages of the purchase price of the installment paper, from the time they were entered on the books of the finance companies as liabilities to the respective dealers, were vested in and belonged to

the respective dealers, subject only to their several pledges thereof to the respective finance companies as collateral security for the payment of their then contingent liabilities to the finance companies.

This brings us to the question whether amounts of purchase price withheld by finance companies as security to cover possible losses on installment paper purchased from dealers, who employ the accrual method of accounting, constitute income to them at the time the withheld amounts are recorded on the books of the finance companies as liabilities to the dealers. . . .

The taxpayers contend, first, that they cannot *presently* compel the finance companies to pay to them the amounts of their reserve accounts, and therefore they have not acquired a *presently enforcible right to recover* those reserves, and, hence, they should not be deemed to constitute accrued income to them. Inasmuch as these records show that the payout period for automobiles varies from 12 to 36 months and for house trailers from 36 to 60 months, it is doubtless true that the taxpayers, having pledged their reserve accounts to the finance companies as collater security, cannot presently compel the finance companies to pay over their reserves. But the question is not whether the taxpayers can presently recover their reserves, for, as stated, it is the time of acquisition of the *fixed right to receive* the reserves and not the time of their *actual receipt* that determines whether or not the reserves have accrued and are taxable.

The taxpayers next contend that the amounts that were retained by the finance companies and entered on their books as liabilities to the dealers under their reserve accounts, were subject to such contingencies that it could not have been known, in the year of such retentions and credits, what amount of those reserves would actually be received by them and, hence, they did not acquire, in the year of such retentions and credits, a fixed right to receive — in a later year or at any time — the amounts so withheld and credited to them, and therefore those amounts did not constitute accrued income to them.

It is true that the amounts retained by any one of the finance companies, and entered on its books as a liability to a particular dealer, are subject to such liabilities as the dealer may have contractually assumed to the finance company, but only the obligations of the dealer to the finance company arising from those liabilities may be offset against a like amount in the dealer's reserve account. Hence, those liabilities and obligations provide the only conditions that can affect full cash payment to the dealer of his reserve account. No amount may be charged by the finance company against the dealer's reserve account which he has not thus authorized.

It follows that only one or the other of two things can happen to the dealer's reserve account: (1) the finance company is bound to pay the full amount to the dealer in cash, or (2) if the dealer has incurred obligations to the finance company under his guaranty, endorsement, or contract of sale, of the installment paper, the finance company may apply so much of the reserve as is necessary to discharge those obligations, and is bound to pay the remainder to the dealer in cash.

Does the dealer "receive" funds which are so taken from his reserve account and applied to the payment of his obligations to the finance company? The dealer agreed in his contract with the finance company to receive his reserve in offset payment of his obligations to the finance company and the balance in cash. It would therefore seem that funds in the dealer's reserve which are applied to the payment of his obligations to the finance company are as much "received" by him as those which the finance company pays to him in cash. . . .

It follows that the amounts (of purchase price of the installment paper) that were withheld by the finance companies constituted accrued income to these accrual basis dealers at the time the withheld amounts were entered on the books of the finance companies as liabilities to the dealers, for at that time the dealers ac-

quired a fixed right to receive the amounts so retained by the finance companies.

The taxpayers complain that such a holding will unfairly require them to pay taxes upon funds which are not available to them for that purpose. Though the funds are not presently available to the taxpayers for the payment of taxes, they are nevertheless owned by the taxpayers, and the latter cannot expect to collateralize their liabilities, for periods running from 1 to 5 years, by the use of their accrued but untaxed funds. Moreover, it is a normal result of the accrual basis of accounting and reporting that taxes frequently must be paid on accrued funds before receipt of the cash with which to pay them. . . .

To permit accrual basis taxpayers to escape accrual and taxation, in a particular year, of such portions of their sales as they may permit to be retained by buyers, as collateral security, well might violate [§451(a)], and, moreover, might well afford opportunities to accrual basis taxpayers to allocate income to years deemed most advantageous.

The Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income, Lucas v. American Code Co., 280 U.S. 445, 449; Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 189-190; and under [§446(b)], the Commissioner, believing that the accounting method employed by a taxpayer "does not clearly reflect the income," may require that "computation shall be made in accordance with such method as in [his] opinion . . . does clearly reflect the income." Since 1931 the Internal Revenue Service has consistently maintained that amounts withheld by finance companies to cover possible losses on notes purchased from dealers constitute income to dealers, who employ the accrual method of accounting, from the time the amounts are recorded on the books of the finance companies as liabilities to the dealers. That position, in general, accords with our view. . . .

MR. JUSTICE DOUGLAS dissents.

MR. JUSTICE BLACK took no part in the consideration or decision of these cases.

NOTE

1. *Legislation re dealers' reserves.* The Dealer Reserve Income Adjustment Act of 1960 was enacted after the *Hansen* case was decided to ease the transition for dealers who were required by the *Hansen* rationale to shift from a different method of reporting their income. See American Community Builders, Inc. v. Commissioner, 301 F.2d 7 (7th Cir. 1962).

May the taxpayers in *Hansen* create a reserve to provide for their liability as guarantors of the discounted notes? See Mike Persia Chevrolet, Inc. v. Commissioner, 41 T.C. 198 (1963), and cases there cited.

2. *Accrual of expenses.* Just as the accrual basis taxpayer must report income when it accrues, even though it has not yet been received in cash or property, so he must deduct expenses when they are incurred, even though payment is postponed. (For the deduction of estimated future expenses, see page 809 infra.) May a taxpayer accrue an expense item if, by reason of his unsound financial condition, it is doubtful whether he will ever be able to pay it? Cohen v. Commissioner, 21 T.C. 855 (1954).

There are some statutory exceptions, however, permitting items to be deducted only if they have been paid. Thus §170(a)(1) permits the deduction of a "charitable contribution . . . payment of which is made during the taxable year"; §404(a) permits the deduction of contributions "paid" by an employer under certain employee benefit plans; §§71(a) and 215(a) require the wife to include and permit the husband to deduct alimony "payments"; §213(a) allows medical expenses "paid during the taxable year" to be deducted; and §561(a) allows a credit (available in computing the personal holding company and §531 surtaxes) for "dividends paid during the taxable year." (In several instances, exceptions have been provided for items paid within a specified time following the close of the taxable year — see §170(a)(2), §404(a)(6), and §563.) Is there any reason why accrual basis taxpayers should be required to employ a cash basis for these items?

See also Regs. §1.301-1(b), providing that a dividend is taxable to shareholders "when

the cash or other property is unqualifiedly made subject to their demands." It has been held that this regulation requires accrual basis taxpayers to report dividends as of the payment date rather than on the record date, thus placing them on a parity with cash basis taxpayers. Commissioner v. American Light & Traction Co., 156 F.2d 398 (7th Cir. 1946).

It has been held that an amount was "paid" by an accrual basis taxpayer when it gave a negotiable demand note to the obligee. Sachs v. Commissioner, 208 F.2d 313 (3d Cir. 1953). The *Price* case, supra page 787, denied a deduction to a cash basis taxpayer who gave a note, but the opinion does not indicate whether the instrument was payable on demand and negotiable.

3. *Disallowance of unpaid expenses owing to related taxpayers.* Section 267(a)(2) might be examined at this point. It finds its principal application when a closely held corporation is on the accrual basis and a dominating stockholder on the cash basis; the corporation cannot deduct accrued salary and interest owing to the individual in question if the amounts are not paid in the taxable year or within two and one-half months thereafter. Why should the corporation's deduction be denied in such circumstances? See Paul, Some Problems Under the New Section 24(c), 32 Taxes 191 (1954).

4. *References.* Holland, Accrual Problems in Tax Accounting, 48 Mich. L. Rev. 149 (1949); Comment, Accrual: The Uncertain Concept of Certainty — A History of the All Events Test, 21 U. of Chi. L. Rev. 293 (1954).

AMERICAN AUTOMOBILE ASSN. v. UNITED STATES

367 U.S. 687 (1961)

MR. JUSTICE CLARK delivered the opinion of the Court.

In this suit for refund of federal income taxes the petitioner, American Automobile Association, seeks determination of its tax liability for the years 1952 and 1953. Returns filed for its taxable calendar years were prepared on the basis of the same accrual method of accounting as was used in keeping its books. The Association reported as gross income only that portion of the total prepaid annual membership dues, actually received or collected in the calendar year, which ratably corresponded with the number of membership months, covered by those dues, occurring within the same taxable calendar year. The balance was reserved for ratable monthly accrual over the remaining membership period in the following calendar year as deferred or unearned income reflecting an estimated future service expense to members. The Commissioner contends that petitioner should have reported in its gross income for each year the entire amount of membership dues actually received in the taxable calendar year without regard to expected future service expense in the subsequent year. The sole point at issue, therefore, is in what year the prepaid dues are taxable as income.

In auditing the Association's returns for the years 1952 through 1954, the Commissioner, in exercise of his discretion under [§446(b)], determined not to accept the taxpayer's accounting system. As a result, adjustments were made for those years principally by adding to gross income for each taxable year the amount of prepaid dues which the Association had received but not recognized as income, and subtracting from gross income amounts recognized in the year although actually received in the prior year. . . .

The Association is a national automobile club organized as a nonstock membership corporation with its principal office in Washington, D.C. It provides a variety of services[1] to the members of affiliated local automobile clubs and those of ten clubs which taxpayer itself directly operates as divisions, but such services are

[1] These generally include road maps, routing, tour books, etc.; emergency road service through contracts with local garages; bail bond protection; personal automobile accident insurance and theft protection; and, in some of its divisions, motor license procurement, brake and headlight adjustment service, notarial duties and advice in the prosecution of small claims.

rendered solely upon a member's demand. Its income is derived primarily from dues paid one year in advance by members of the clubs. Memberships may commence or be renewed in any month of the year. For many years, the association has employed an accrual method of accounting and the calendar year as its taxable year. It is admitted that for its purposes the method used is in accord with generally accepted commercial accounting principles. The membership dues, as received, were deposited in the Association's bank accounts without restriction as to their use for any of its corporate purposes. However, for the Association's own accounting purposes the dues were treated in its books as income received ratably[2] over the 12-month membership period. The portions thereof ratably attributable to membership months occurring beyond the year of receipt, i.e., in a second calendar year, were reflected in the Association's books at the close of the first year as unearned or deferred income. Certain operating expenses were chargeable as prepaid membership cost and deducted ratably over the same periods of time as those over which dues were recognized as income.

The Court of Claims bottomed its opinion on Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957), finding that "the method of treatment of prepaid automobile club membership dues employed [by the Association here was] . . . for Federal income tax purposes, 'purely artificial.'" 181 F. Supp. 255, 258. It accepted that case as "a rejection by the Supreme Court of the accounting method advanced by plaintiff in the case at bar." Ibid. The Association does not deny that its accounting system is substantially identical to that used by the petitioner in *Michigan*. It maintains, however, that *Michigan* does not control this case because of a difference in proof, i.e., that in this case the record contains expert accounting testimony indicating that the system used was in accord with generally accepted accounting principles; that its proof of cost of member service was detailed, and that the correlation between that cost and the period of time over which the dues were credited as income was shown and justified by proof of experience. The holding of *Michigan,* however, that the system of accounting was "purely artificial" was based upon the finding that "substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year." 353 U.S. 180, 189, note 20. That is also true here. As the Association's own accounting expert testified:

> You are dealing with a group or pool. Any pooling or risk situation, particular members may in a particular year require very little of a specific service that is rendered to certain other members. I wouldn't know what the experience on that would be, but I would think it would be rather irregular between individual members . . . I am buying the availability of services, the protection . . . Frankly, the irregularity of the actual furnishing of the maps and helping you out when you run out of gasoline and so on. I frankly don't think that has a blessed thing to do with the overall accounting.

It may be true that to the accountant the actual incidence of cost in serving an individual member in exchange for his individual dues is inconsequential, or, from the viewpoint of commercial accounting, unessential to determination and disclosure of the overall financial condition of the Association. That "irregularity," however, is highly relevant to the clarity of an accounting system which defers receipt, as earned income, of dues to a taxable period in which no, some,

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[2] In 1952 and 1953 dues collected in any month were accounted as income to the extent of one-twenty-fourth for that month (on the assumption that the mean date of receipt was the middle of the month), one-twelfth for each of the next eleven months, and again one-twenty-fourth in the anniversary month. In 1954, however, guided by its own statistical average experience, the Association changed its system so as to more simply reach almost the same result by charging to year of receipt, without regard to month of receipt, one-half of the entire dues payment and deferring the balance to the following year.

or all the services paid for by those dues may or may not be rendered. The Code exacts its revenue from the individual member's dues which, no one disputes, constitute income. When their receipt as earned income is recognized ratably over two calendar years, without regard to correspondingly fixed individual expense or performance justification, but consistently with overall experience, their accounting doubtless presents a rather accurate image of the total financial structure, but fails to respect the criteria of annual tax accounting and may be rejected by the Commissioner.

The Association further contends that the findings of the court below support its position. We think not. The Court of Claims' only finding as to the accounting system itself is as follows:

> 22. The method of accounting employed by plaintiff during the years in issue has been used regularly by plaintiff since 1931 and is in accord with generally accepted commercial accounting principles and practices and was, prior to the adverse determination by the Commissioner of the Internal Revenue, customarily and generally employed in the motor club field.

This is only to say that in performing the function of business accounting the method employed by the Association "is in accord with generally accepted commercial accounting principles and practices." It is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury. Likewise, other findings merely reflecting statistical computations of average monthly cost per member on a group or pool basis are without determinant significance to our decision that the federal revenue cannot, without legislative consent and over objection of the Commissioner, be made to depend upon average experience in rendering performance and turning a profit. Indeed, such tabulations themselves demonstrate the inadequacy from an income tax standpoint of the pro rata method of allocating each year's membership dues in equal monthly installments not in fact related to the expenses incurred. Not only did individually incurred expenses actually vary from month to month, but even the average expense varied — recognition of income nonetheless remaining ratably constant. Although the findings below seem to indicate that it would produce substantially the same result as that of the system of ratable monthly recognition actually employed, we consider similarly unsatisfactory, from an income tax standpoint, allocation of monthly dues to gross monthly income to the extent of actual service expenditures for the same month computed on a group or pool basis. In addition, the Association's election in 1954 to change its monthly recognition formula to one which treats one-half of the dues as income in the year of receipt and the other half as income received in the subsequent year, without regard to month of payment, only more clearly indicates the artificiality of its method, at least so far as controlling tax purposes are concerned. Moreover, the Association realized that the findings of the Court of Claims were not alone sufficient for its purposes. In its petition for rehearing below, petitioner specifically asked that they be amended and enlarged, especially as to No. 22 set out above. Rehearing and amendment were denied.

Whether or not the Court's judgment in *Michigan* controls our disposition of this case, there are other considerations requiring our affirmance. They concern the action of the Congress with respect to its own positive and express statutory authorization of employment of such sound commercial accounting practices in reporting taxable income. In 1954 the Congress found dissatisfaction in the fact that "as a result of court decisions and rulings, there have developed many divergencies between the computation of income for tax purposes and income for business purposes as computed under generally accepted accounting principles. The

areas of difference are confined almost entirely to questions of when certain types of revenue and expenses should be taken into account in arriving at net income." House Ways and Means Committee Report, H.R. Rep. No. 1337, 83d Cong., 2d Sess. 48. As a result, it introduced into the Internal Revenue Code of 1954 §452 and §462 which specifically permitted essentially the same practice as was employed by the Association here.[3] Only one year later, however, in June 1955, the Congress repealed these sections retroactively. It appears that in this action Congress first overruled the long administrative practice of the Commissioner and holding of the courts in disallowing such deferral of income for tax purposes and then within a year reversed its own action. This repeal, we believe, confirms our view that the method used by the Association could be rejected by the Commissioner. While the claim is made that Congress did not "intend to disturb prior law as it affected permissible accrual accounting provisions for tax purposes. . . ." H.R. Rep. No. 293, 84th Cong., 1st Sess. 4, the cold fact is that it repealed the only law incontestably permitting the practice upon which the Association depends. To say that, as to taxpayers using such systems, Congress was merely declaring existing law when it adopted §452 in 1954, and that it was merely restoring unaffected the same prior law when it repealed the new section in 1955 for good reason, is a contradiction in itself, "varnishing nonsense with the charm of sound." Instead of constituting a merely duplicative creation, the fact is that §452 for the first time specifically declared petitioner's system of accounting to be acceptable for income tax purposes, and overruled the long-standing position of the Commissioner and courts to the contrary. And the repeal of the section the following year, upon insistence by the Treasury that the proposed endorsement of such tax accounting would have a disastrous impact on the Government's revenue,* was just as clearly a mandate from the Congress that petitioner's system was not acceptable for tax purposes. To interpret its careful consideration of the problem otherwise is to accuse the Congress of engaging in sciamachy. We are further confirmed in this view by consideration of the even more recent action of the Congress in 1958, subsequent to the decision in *Michigan,* supra. In that year §455 was added to the Internal Revenue Code of 1954. It permits publishers to defer receipt as income of prepaid subscriptions of newspapers, magazines and periodicals. An effort was made in the Senate to add a provision in §455 which would extend its coverage to prepaid automobile club membership dues. However, in conference the House Conferees refused to accept this amendment. Senator Byrd explained the rejection of the amendment to the Senate (104 Cong. Rec., Part 14, p. 17744):

> It was the position of the House conferees that this matter of prepaid dues and fees received by nonprofit service organizations was a part of the entire subject dealing with the treatment of prepaid income and that such subject should be left for study of this entire problem. . . .

It appears, therefore, that, pending its own further study, Congress has given publishers but denied automobile clubs the very relief that the Association seeks in this Court.

To recapitulate, it appears that Congress has long been aware of the problem this case presents. In 1954 it enacted §452 and §462, but quickly repealed them. Since that time Congress has authorized the desired accounting only in the instance of prepaid subscription income, which, as was pointed out in *Michigan,*

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[3] The Senate Report included this language:

"Under the 1939 Code, regardless of the method of accounting . . . amounts are includible in gross income by the recipient not later than the time of receipt if they are subject to free and unrestricted use by the taxpayer even though the payments are for goods or services to be provided by the taxpayer at a future time." S. Rep. No. 1622, 83d Cong., 2d Sess 301.

* See paragraph 2 of editor's note, infra page 805. — Ed.

is ratably earned by performance on "publication dates after the tax year." 353 U.S. 180, 189, note 20. It has refused to enlarge §455 to include prepaid membership dues. At the very least, this background indicates congressional recognition of the complications inherent in the problem and its seriousness to the general revenue. We must leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications. The Committees of the Congress have standing committees expertly grounded in tax problems, with jurisdiction covering the whole field of taxation and facilities for studying considerations of policy as between the various taxpayers and the necessities of the general revenues. The validity of the long established policy of the Court in deferring, where possible, to congressional procedures in the tax field is clearly indicated in this case. Finding only that, in light of existing provisions not specifically authorizing it, the exercise of the Commissioner's discretion in rejecting the Association's accounting system was not unsound, we need not anticipate what will be the product of further "study of this entire problem."

Affirmed.

MR. JUSTICE STEWART, whom MR. JUSTICE DOUGLAS, MR. JUSTICE HARLAN and MR. JUSTICE WHITTAKER join, dissenting.

In Automobile Club of Michigan the Court pointed out that the method of accounting employed by the taxpayer was "purely artificial," so far as the record there showed. 353 U.S., at 189. Here, by contrast, the petitioner proved, and the Court of Claims found, that the method of accounting employed by the petitioner during the years in issue was in accord with generally accepted commercial accounting principles and practice, was customarily employed by similar taxpayers, and, in the opinion of qualified experts in the accounting field, clearly reflected the petitioner's net income. I do not understand that the Court today questions either that proof or those findings.

The Court thus holds that the Commissioner is authorized to disregard and override a method of reporting income under which prepaid dues are deferred in direct relation to the taxpayer's costs under its membership contracts. The effect of the Court's decision is to allow the Commissioner to prevent an accrual basis taxpayer from making returns in accordance with the accepted and clearly valid accounting practice of excluding from gross income amounts received as advances until the right to such amounts is earned by rendition of the services for which the advances were made. To permit the Commissioner to do this, I think, is to ignore the clear statutory command that a taxpayer must be allowed to make his returns in accord with his regularly employed method of accounting, so long as that method clearly reflects his income. The result, I am afraid, will be to engender far-reaching confusion and injustice in the administration of the Internal Revenue Laws.[1]

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1 The scope of the problem is well illustrated by the reported cases. See, e.g., South Dade Farms v. Commissioner, 138 F.2d 818 (rent received in advance); Clay Sewer Pipe Assn. v. Commissioner, 139 F.2d 130 (subscriptions for promotion campaign to be consummated in years subsequent to receipt); Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (advance newspaper subscription payments); Bressner Radio, Inc. v. Commissioner, 267 F.2d 520 (advance payments in a television servicing contract); Schlude v. Commissioner, 283 F.2d 234 (fees for dancing lessons paid in advance); Wallace A. Moritz, 21 T.C. 622 ("customers' deposits" on undeveloped photographs); South Tacoma Motor Co., 3 T.C. 411 (proceeds from sale of coupons entitling bearer to garage services in later years); Your Health Club, Inc., 4 T.C. 385 (advance payments for use of gym and other facilities); Northern Illinois College of Optometry, ¶43,396 P-H Memo T.C.

I

The Commissioner's basic argument against the deferred reporting of prepayments has traditionally been that such a method conflicts with a series of decisions of this Court which establish the so-called "claim of right doctrine." In this case the Government abandoned that argument, with good reason. As four Circuits have correctly held, the claim of right doctrine furnishes no support for the Government's position. Bressner Radio, Inc., v. Commissioner, 267 F.2d 520, 524, 525-528 (C.A. 2d Cir.); Schlude v. Commissioner, 283 F.2d 234 (C.A. 8th Cir.); Schuessler v. Commissioner, 230 F.2d 722, 725 (C.A. 5th Cir.); Beacon Publishing Co. v. Commissioner, 218 F.2d 697, 699-701 (C.A. 10th Cir.). A claim of right without "restriction on use" may be the crucial factor in determining that particular funds are includable in gross income. See North American Oil v. Burnet, 286 U.S. 417; United States v. Lewis, 340 U.S. 590; Healy v. Commissioner, 345 U.S. 278. But it hardly follows that all such funds must necessarily be reported by an accrual basis taxpayer as income in the year of receipt, whether or not then earned.

The Government shifted its argument in this case to the contention that the "annual accounting requirement" demands that "[n]either income nor deduction items may be accelerated or postponed from one taxable year to another in order to reflect the long-term economic result of a particular transaction or group of transactions." The Government finds a basis for this argument in such cases as Security Mills Co. v. Commissioner, 321 U.S. 281; Brown v. Helvering, 291 U.S. 193; Burnet v. Sanford & Brooks Co., 282 U.S. 359; Guaranty Trust Co. v. Commissioner, 303 U.S. 493; and Heiner v. Mellon, 304 U.S. 271.

The Court today does not base its decision on this theory, presumably because the Court believes, as I do, that the theory is not valid. Putting to one side the point that many of the cases relied on involved cash basis taxpayers, these decisions no more pertain to deferred reporting of totally unearned receipts than do the claim of right decisions. These cases, like the claim of right cases, start from the premise that the income in question has been fully earned.[2] The underlying premise of the annual accounting requirement is that *otherwise reportable income* derived from a transaction cannot be excluded from gross income in order to let the taxpayer wait to see in a later year how the overall transaction turns out. This is not the issue in this case. The question here is whether any reportable income has been derived from a transaction when payments are received in advance of performance.

Although wisely rejecting the claim of right and annual accounting arguments, the Court decides this case upon grounds which seem to me equally invalid. I can find nothing in *Automobile Club of Michigan* which controls disposition of this case. And the legislative history upon which the Court alternatively relies seems to me upon examination to be singularly unconvincing.

In *Michigan* there was no offer of proof to show the rate at which the taxpayer fulfilled its obligations under its membership contracts. The deferred reporting of prepaid dues was, therefore, rejected in that case simply because there was no showing of a correlation between the amounts deferred and the costs incurred by the taxpayer in carrying out its obligations to its members. Until today, that case has been recognized as one that simply held that, in the absence of proof that the proration used by the taxpayer reasonably matched actual expenses with the earning of related revenue, the Commissioner was justified in rejecting the taxpayer's proration. I am hardly alone in thinking that *Michigan* was decided

[2] With the possible exception of contingent related expenditures, which cannot be accurately measured. See Brown v. Helvering, 291 U.S. 193, 200-201.

upon the very premise that a realistic deferral of income based upon proof of average costs of service during identifiable periods would be entirely permissible. See Bressner Radio, Inc. v. Commissioner, 267 F.2d 520, 526-529. Such proof was concededly adduced in this case.

As to the enactment and repeal of §452 and §462, upon which the Court places so much reliance, . . . I think that the enactment and subsequent repeal of §452 and §462 give no indication of Congressional approval of the position taken by the Commissioner in this case. If anything, the legislative action leads to the contrary impression.

The statutory provisions in question were passed as part of a general revision of the internal revenue laws in 1954. Section 452 permitted an accrual basis taxpayer to defer the inclusion of advances in gross income until they were earned. Most significantly, a taxpayer could shift to this method without the consent of the Commissioner. Section 462, which permitted the deduction of anticipated expenses, was not aimed specifically at the problem of reporting advances. The function of the provisions was to bring "[t]ax accounting . . . more nearly in line with accepted business accounting by allowing prepaid income to be taxed as it is earned rather than as it is received, and by allowing reserves to be established for known future expenses."

In seeking to accomplish this objective, Congress recognized that as a result of "court decisions and rulings," the claim of right approach had been used to require reporting for the year of receipt all payments "subject to free and unrestricted use . . . even though the payments are for goods or services to be provided by the taxpayer at a future time." H.R. Rep. No. 1337, 83d Cong., 2d Sess. 48, A159. Congressional awareness of administrative and judicial misapplication of the claim of right doctrine clearly did not imply approval of it. For by 1954, "[i]t was long recognized that the difficulty lay, not with the statute, but with administrative and court interpretation." And while the Committee reports contain no express rejection of the Commissioner's interpretation of the 1939 statute, the language used in explaining the need for a change certainly indicates disapproval.

Although §452 and §462 were short-lived, the shape of the decisional law with respect to §41 of the 1939 Code [§446(a) and (b), 1954 Code] changed considerably during the interval between the passage and repeal of the new sections. In Beacon Publishing Co. v. Commissioner, 218 F.2d 697, the Tenth Circuit rejected the Commissioner's reliance on the claim of right rationale and found that the deferment of advances in accord with accrual principles did "clearly reflect . . . income" under §41. At about the same time a Ninth Circuit decision permitted income received from the sale of goods to be offset by a deduction for the future expense of shipping the goods. Pacific Grape Products Co. v. Commissioner, 219 F.2d 862.

When Congress repealed §452 and §462, the record shows that it was fully aware of these decisions. Congress recognized that the rationale of these cases would produce a complete reversal of the previous administrative position with respect to the reporting of unearned receipts under §41 and its counterpart under the 1954 Code, §446. Congressional intent with respect to this possibility was entirely clear — the trend of judicial decisions should be allowed to run its course *without any inference of disapproval being drawn from the repeal of §452 and §462.*

[Mr. Justice Stewart here quoted from a letter from the Secretary of the Treasury to the Chairman of the House Committee on Ways and Means, stating that "the Treasury Department will not consider the repeal of section 452 as any indication of congressional intent as to the proper treatment of prepaid subscriptions and other items of prepaid income, either under prior law or under other prov

sions of the 1954 Code," and from a similar statement in the Senate Report on the repeal legislation itself.]

To my mind, this legislative history shows that Congress made every effort to dissuade the courts from doing exactly what the Court is doing in this case — drawing from the repeal of §452 an inference of Congressional disapproval of deferred reporting of advances. But even if the legislative history on this point were hazy, the same conclusion would have to be reached upon examination of Congressional purpose in repealing §452 and §462. Cf. United States v. Benedict, 338 U.S. 692, 696. For the fact of the matter is, contrary to the impression left by the Court's opinion, that the reasons for rejecting §452 and §462 were entirely consistent with accepting the deferred reporting of receipts in a case like this. Sections 452 and 462 were repealed *solely* because of a prospective loss of revenue during the first year in which taxpayers would take advantage of the new sections. Insofar as the reporting of advances was concerned, that loss of revenue would have occurred solely as a consequence of taxpayers changing their method of reporting, without the necessity of securing the Commissioner's consent, to that authorized under §452 and §462. The taxpayer who shifted his basis for reporting advances would have been allowed what was commonly termed a "double deduction" during the transitional year. Under §462, deductions could be taken in the year of change for expenses attributable to advances taxed in prior years under a claim of right theory, as well as for reserves for future expenditures attributable to advances received and reported during that year. Similarly, under §452, prepayments received during the year of transition would be excluded from gross income while current expenditures attributable to past income would still be deductible.

The Congressional purpose in repealing §452 and §462 — maintenance of the revenues — does not, however, require disapproval of sound accounting principles in cases of taxpayers who, like the petitioner, have customarily and regularly used a sound accrual accounting method in reporting advance payments. No transition is involved, and no "double deduction" is possible. Moreover, taxpayers formerly reporting advances as income in the year of receipt can now shift to a true accrual system of reporting only with the approval of the Commissioner. See Treas. Reg. 111, §29.41-2 (1942); Treas. Reg. 118, §39.41-2(c) (1953); Int. Rev. Code of 1954, §446(e). Before giving his approval the Commissioner can be expected to insist upon adjustments in the taxpayer's transition year to forestall any revenue loss which would otherwise result from the change in accounting method. See Kahuku Plantation Co. v. Commissioner, 132 F.2d 671, 674; 2 Mertens, Law of Federal Income Taxation, §§12.21, 12.21a. Cf. Brown v. Helvering, 291 U.S. 193, 204.

In short, even if the legislative history of the repeal of §452 and §462 did not clearly indicate, as it does, that the repeal of those sections should have no bearing upon judicial determination of whether the deferred reporting of advances "clearly reflects income," the purpose of the Congress which repealed those provisions would lead to the same conclusion. It need hardly be added that the subsequent legislative activity cited by the Court in no way alters this conclusion. Contrary to the Court's suggestion, the "relief that the Association seeks in this Court" is far short of what was sought in 1958 in urging that the coverage of §455 be extended to prepaid automobile club membership dues. As enacted, §455 was not limited in application to publishers previously reporting prepaid subscriptions on a deferral basis. See I.T. 3369, 1940-1 Cum. Bull. 46. It applied to all publishers using the accrual method and permitted a change to deferred reporting of subscriptions for the year 1958 *without consent* of the Commissioner. §455(c)(3)(B).

I think the Government's position in this case is at odds with the statutes, regulations, and court decisions, which, since 1916, have recognized that realistic accrual accounting does "clearly reflect income." If I am correct, the law did not give the Commissioner any "discretion . . . not to accept the taxpayer's accounting system."

The basic concept of including advances in gross income only as they are earned is but an aspect of accrual accounting principles which have consistently received judicial approval. We have, for example, often recognized that deductions for business expenses must be reported as soon as the obligation to pay becomes "certain." See, e.g., United States v. Anderson, 269 U.S. 422; American National Co. v. United States, 274 U.S. 99; Niles Bement Pond Co. v. United States, 281 U.S. 357, 360; United States v. Olympic Radio and Television, 349 U.S. 232, 236. This may be before or after cash payment is made, or even before it is due. The controlling factor is not the flow of cash, but the "economic and bookkeeping" principles with which [§446] is concerned. United States v. Anderson, supra, at 441. See also American National Co. v. United States, supra. These principles are at the foundation of the so-called "all events" test for determining the accrual of deductions. See United States v. Anderson, supra, at 441; United States v. Consolidated Edison Co., 366 U.S. 380. The same principles are applicable to the accrual of income. See Continental Tie & L. Co. v. United States, 286 U.S. 290. As has been correctly noted, "[i]t is a necessary corollary of this 'economic and bookkeeping' proposition" upon which *Anderson* rested that receipts are not reportable in income until "substantially 'all the events' have occurred, both as to the cost and time of performance, which must occur in order to discharge the liability to perform which was given by [the taxpayer] in return for the receipt." Bressner Radio, Inc., v. Commissioner, 267 F.2d 520, 524. See also United States v. Anderson, supra, at 440; Beacon Publishing Co. v. Commissioner, 218 F.2d 697, 699. Indeed, "accrual" of income has been commonly defined in terms of "earnings" from the sale of goods or the performance of services. See, e.g., Spring City Co. v. Commissioner, 292 U.S. 182, 184-185; Stanley and Kilcullen, The Federal Income Tax (3d ed. 1955), 190. In rejecting petitioner's method of allocating prepaid advances, the Court, I think, disregards these basic principles.

The net effect of compelling the petitioner to include all dues in gross income in the year received is to force the petitioner to utilize a hybrid accounting method — a cash basis for dues and an accrual basis for all other items. Schlude v. Commissioner, 283 F.2d 234, 239. Cf. Commissioner v. South Texas Co., 333 U.S. 496, 501. For taxpayers generally the enforcement of such a hybrid accounting method may result in a gross distortion of actual income, particularly in the first and last years of doing business. On the return for the first year in which advances are received, a taxpayer will have to report an unrealistically high net income, since he will have to include unearned receipts, without any offsetting deductions for the future cost of earning those receipts. On subsequent tax returns, each year's unearned prepayments will be partially offset by the deduction of current expenses attributable to prepayments taxed in prior years. Even then, however, if the taxpayer is forbidden to correlate earnings with related expenditures, the result will be a distortion of normal fluctuations in the taxpayer's net income. For example, in a year when there are low current expenditures because of fewer advances received in the preceding year, the result may be an inflated adjusted gross income for the current year. Finally, should the taxpayer decide to go out of business upon fulfillment of the contractual obligations already undertaken, in the final year there will be no advances to report and many costs attributable to

advances received in prior years. The result will be a grossly unrealistic reportable net loss.

The Court suggests that the application of sound accrual principles cannot be accepted here because deferment is based on an estimated rate of earnings, and because this estimate, in turn, is based on average, not individual, costs. It is true, of course, that the petitioner cannot know what service an individual member will require or when he will demand it. Accordingly, in determining the portion of its outstanding contractual obligations which have been discharged during a particular period (and hence the portion of receipts earned during that period), the petitioner can only compare the total expenditures for that period against estimated average expenditures for the same number of members over a full contract term. But this use of estimates and averages is in no way inconsistent with long-accepted accounting practices in reflecting and reporting income. As the Government has pointed out in past litigation, "many business concerns . . . keep accounts on an accrual basis and have to estimate for the tax year the amount to be received on transactions undoubtedly allocable to such year." Continental Tie & L. Co. v. United States, 286 U.S. 290, 295-296. Similarly, the deduction of future expenditures which have already accrued often requires estimates like those involved here. See, e.g., Harrold v. Commissioner, 192 F.2d 1002; Schuessler v. Commissioner, 230 F.2d 722; Denise Coal Co. v. Commissioner, 271 F.2d 930, 934-937; Hilinski v. Commissioner, 237 F.2d 703. Finally, it is to be noted that the regulations under both the 1939 and 1954 Codes permit various methods of reporting income which require the use of estimates.[3] In the absence of any showing that the estimates used here were faulty, I think the law did not permit the Commissioner to forbid the use of standard accrual methods simply upon the ground that estimates were necessary to determine what the rate of deferral should be.

Similarly, it is not relevant that the petitioner "defers receipt . . . of dues to a taxable period in which no, some, or all the services paid for by those dues may or may not be rendered." The fact of the matter is that what the petitioner has an obligation to provide, i.e., the constant readiness of services if needed, will with certainty be provided during the period to which deferment has been made. Averages are frequently utilized in tax reporting. In computing the value of work in process, in distributing overhead to product cost, and in various other areas, the use of averages has long been accepted. See, e.g., Rookwood Pottery Co. v. Commissioner, 45 F.2d 43; Eatonville Lumber Co., 10 B.T.A. 232. The use of an "average cost" is particularly appropriate here where the dues are earned by making services continuously available. The cost of doing so must necessarily be based on composite figures.

For these reasons I think that the petitioner's original return clearly reflected its income, that the Commissioner was therefore without authority under the law to override the petitioner's accounting method, and that the judgment should be reversed.

NOTE

1. *Prepaid lessons.* In Schlude v. Commissioner, 371 U.S. 884 (1963), the Supreme Court held (5-to-4) that a dancing school was taxable in the year of receipt on amounts paid by students for lessons to be rendered in the future; the school's consistent practice had been

[3] See, e.g., Treas. Reg. §1.451-3 (1957) (providing for the percentage of completion method of reporting income on long-term contracts); Treas. Reg. §1.451-4 (1957) (providing for the deduction for redemption of trading stamps based upon "the rate, in percentage, which the stamps redeemed in each year bear to the total stamps issued in such year"). See generally Brown & Williamson Tobacco Corp., 16 T.C. 432.

to treat such payments as deferred income, to be recognized in aliquot portions as the lessons were given or when the student's lack of activity indicated that no more lessons would be called for. The majority relied in part on its discussion in the *AAA* case of the retroactive repeal of §452 and the limited scope of the subsequently enacted §456, and added:

> The *American Automobile Association* case rested upon an additional ground which is also controlling here. Relying upon Automobile Club of Michigan v. Commissioner, 353 U.S. 180, the Court rejected the taxpayer's system as artificial since the advance payments related to services which were to be performed only upon customers' demands without relation to fixed dates in the future. The system employed here suffers from that very same vice, for the studio sought to defer its cash receipts on the basis of contracts which did not provide for lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the instructor and his student. Under the contracts, the student could arrange for some or all of the additional lessons or could simply allow their rights under the contracts to lapse. But even though the student did not demand the remaining lessons, the contracts permitted the studio to insist upon payment in accordance with the obligations undertaken and to retain whatever prepayments were made without restriction as to use and without obligation of refund. At the end of each period, while the number of lessons taught had been meticulously reflected, the studio was uncertain whether none, some or all of the remaining lessons would be rendered. Clearly, services were rendered solely on demand in the fashion of the *American Automobile Association* and *Automobile Club of Michigan* cases.[1]
>
> Moreover, percentage royalties and sales commissions for lessons sold, which were paid as cash was received from students or from its note transactions with the bank, were deducted in the year paid even though the related items of income had been deferred, at least in part, to later periods. In view of all these circumstances, we hold the studio's accrual system vulnerable under §41 [1939 Code] and §446(b) [1954 Code] with respect to its deferral of prepaid income. Consequently, the Commissioner was fully justified in including payments in cash or by negotiable note in gross income for the year in which such payments were received. If these payments are includible in the year of receipt because their allocation to a later year does not clearly reflect income, the contract installments are likewise includible in gross income, as the United States now claims, in the year they become due and payable. For an accrual basis taxpayer "it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income," Spring City Co. v. Commissioner, 292 U.S. 182, 184; Commissioner v. Hansen, 360 U.S. 446, and here the right to receive these installments had become fixed at least at the time they were due and payable. [372 U.S. at 136-137.]

The dissenters said, in part:

> In the present case the difficulties which the Court perceived in *Automobile Club of Michigan* and *American Automobile Association* have been entirely eliminated in the accounting system which these taxpayers have consistently employed. The records kept on individual students accurately measured the amount of services rendered — and therefore the costs incurred by the taxpayer — under each individual contract during each taxable year. But, we are told, there is a fatal flaw in the taxpayers' accounts in this case too: The individual contracts did not provide "for lessons on fixed dates . . . , but left such dates to be arranged from time to time by the instructor and his student." Yet this "fixed date of performance" standard, it turns out, actually has nothing whatever to do with those aspects of the taxpayers' accounting system which the Court ultimately finds objectionable.

1 The treatment of "gains from cancellations" underlines this aspect of the case. These gains, representing amounts paid or promised in advance of lessons given, were recognized in those periods in which the taxpayers arbitrarily decided the contracts were to be deemed canceled. The studio made no attempt to report estimated cancellations in the year of receipt, choosing instead to defer these gains to periods bearing no economic relationship to the income recognized. Cf. Continental Tie & Lumber Co. v. United States, 286 U.S. 290.

There is nothing in the Court's opinion to indicate disapproval of the basic method by which income earned by the rendition of services was recorded. On the contrary, the taxpayers' system was admittedly wholly accurate in recording lessons given under each individual contract. It was only in connection with lessons which had not yet been taught that the taxpayers were "uncertain whether none, some or all" of the contractual services would be rendered, and the condemned "arbitrariness" therefore is limited solely to the method by which cancellations were recognized. It is, of course, true of all businesses in which services are not rendered simultaneously with payment that the number and amount of cancellations are necessarily unknown at the time advances are received. But surely it cannot be contended that a contract which specified the times at which lessons were to be given would make any more certain how many of the remaining lessons students would in fact demand. Indeed, the Court does not suggest that a schedule fixing the dates of all future lessons would, if embodied in each contract, suffice to make petitioners' accounting system "clearly reflect income."

Instead, the cure suggested by the Court for the defect which it finds in the accounting system used by these taxpayers is that estimated cancellations should be reported as income in the year advance payments are received. I agree that such estimates might more "clearly reflect income" than the system actually used by the taxpayers. But any such estimates would necessarily have to be based on precisely the type of statistical evaluations which the Court struck down in the *American Automobile Association* case. Whatever other artificialities the exigencies of revenue collection may require in the field of tax accounting, it has never before today been suggested that a consistent method of accrual accounting, valid for purposes of recognizing income, is not equally valid for purposes of deferring income. Yet in this case the Court says that the taxpayers, in recognizing income, should have used the very system of statistical estimates which, for income deferral purposes, the *American Automobile* decision held impermissible. [372 U.S. at 142-143.]

For the *Schlude* case on remand, see ¶63,307 P-H Memo T.C.; see also Behren, Supreme Court in Schlude Holds Prepaid Income Taxable on "Receipt"; Rationale Is Uncertain, 18 J. Taxation 194 (1963).

2. *The short, unhappy lives of §452 and §462.* As paragraph 9(b) of the American Accounting Association's "Accounting Principles and Taxable Income" (supra p. 776) indicates, accountants have frequently criticized the Treasury's attitude toward prepaid income and expenses reserves; indeed, these are probably the most important departures, in computing taxable income, from conventional accounting methods. It was, therefore, regarded as a great victory for "generally accepted accounting principles" when §§452 and 462 of the 1954 Code were enacted.

Section 452 permitted "prepaid income" to be spread over an appropriate number of future years. The term "prepaid income" was defined as "any amount (includible in gross income) which is received in connection with, and is directly attributable to, a liability [to render services, furnish goods or other property, or allow the use of property] which extends beyond the close of the taxable year in which such amount is received." §452(c).

Section 462 provided that in computing taxable income, "there shall be taken into account (in the discretion of the Secretary or his delegate) a reasonable addition to each reserve for estimated expenses to which this section applies." The Senate Report on the 1954 Code stated (pp. 306-307):

The Secretary or his delegate must be satisfied that the expenses can be estimated with reasonable accuracy. For example, if cash discounts are allowed customers for prompt payment, and the taxpayer can predict from experience the approximate percentage of the allowable discounts which will be taken (even though he cannot name the customers with certainty) he will be permitted a deduction in the year in which the sales are reported equal to the discounts which will be realized in the process of collecting the accounts. If repairs or replacements will have to be made under guaranty on products sold during the year, and the average cost of such repairs or replacements can be estimated with reasonable accuracy, the taxpayer may take as a deduction in the year of such sales a reasonable addition to a reserve for product guaranties. The balance in the reserve at the close of each taxable year must be adjusted to reflect the estimated liability of the taxpayer with respect to outstanding guaranties. Other

illustrative items for which such reserves might be set up in appropriate cases include sales returns and allowances, freight allowances, quantity discounts, vacation pay, and certain liabilities for self-insured injury and damage claims. The Secretary or his delegate may disallow additions to any reserve of this type if he finds that the costs and expenses for which provision is made are not reasonably supported by the taxpayer. . . .

The reserve method is not to be allowed for costs and expenses of a contingent or contested nature and as to which there is no reasonable certainty of their amount. Reserves created for general undetermined contingencies, indefinite possible future losses, expenses and losses not reasonably related to the taxable year, or for specific expenses and losses that are being contested or are in litigation, cannot ordinarily be estimated with reasonable accuracy and are not to be the basis for additions to reserves under this section.

When §§452 and 462 were enacted, it was estimated that the revenue loss from these and all other accounting provisions of the 1954 Code would be under $50 million. Less than a year later, the Treasury asked Congress to repeal §§452 and 462 on the ground that they would cause a serious revenue loss (as much as several billion dollars, according to some estimates) during the transitional period, when taxpayers began to defer prepaid income and to deduct estimated expenses, since during this period they would continue to deduct the actual costs of servicing old contracts.

In reporting out the bill to repeal §452 and §462, the Senate Finance Committee said of the problem of lost revenue in the year taxpayers shifted to a reserve method of providing for expenses:

As indicated above, your committee last year recognized this problem in the timing of deductions where a taxpayer converts to the expense reserve method and believed that [§462] met the problem by giving the Secretary of the Treasury discretion over not only the amount of estimated expense to be added to the reserve for each taxable year but also the kind of items which entered into the estimated reserve. With such limitations in the section, it was the opinion of your committee that any revenue loss which might occur would be well within the limits of last year's estimate. It would appear possible, for example, for the Secretary to require the spreading of the deductions for actual expenses incurred in the year of transition to the reserve method, over an extended period of years. . . . It apparently is the opinion of the Secretary of the Treasury, however, that the words "in the discretion of the Secretary or his delegate" only limit the amount of the allowable deductions and not the type of items which can be deducted. . . . The Secretary apparently is fearful of exercising the discretion which your committee intended him to have in this matter. He has expressed the view that some taxpayers may contest his decisions and that there may be prolonged litigation before the matter is ultimately decided.

It is because of the Secretary's fears and his desire to have a fresh review of section 462, relating to estimated expenses, and its counterpart section 452, relating to prepaid income, and because of the House action repealing these sections that your committee has reluctantly concluded to report out the House bill repealing these sections from the effective date of their enactment. Since the Secretary has not, by regulations, exercised the discretionary limitations which your committee delegated to him in the law, it is apparent that the loss in revenue under these provisions may be much larger than was anticipated last year.

The Senate Finance Committee also said:

Your committee desires to make its position clear that it expects to report out legislation dealing with prepaid income and reserves for estimated expenses at an early date. As indicated above, the existing rulings of the Treasury Department and the court decisions dealing with estimated expenses and prepaid income are now in such a state of confusion and uncertainty that in the opinion of your committee legislative action is required on these subjects. In addition, your committee believes that it is essential that the income tax laws be brought into harmony with generally accepted accounting principles. Moreover, your committee believes that the present status,

where some taxpayers are able to defer prepaid income while others are not, is inequitable and should not be allowed to continue. In order to eliminate this uncertainty and discrimination, definite rules must be written into the income tax law. For these reasons your committee plans to begin studies in the near future to devise proper substitutes for the sections now being repealed. [S. Rept. No. 372, 84th Cong., 1st Sess., reprinted in 1955-2 C.B. 858, 860-861.]

Despite this assurance by the committee, no general legislation has been enacted since §452 and §462 were repealed.

3. *The legislative sequel to the AAA case.* Following the decision in American Automobile Assn. v. United States, Congress enacted §456 to permit membership organizations to elect to spread prepaid dues over the period of their liability for the performance of services. The provision has much in common with §455 (prepaid subscription income), to which both the majority and the dissenters in the *AAA* case referred.

SCHUESSLER v. COMMISSIONER
230 F.2d 722 (5th Cir. 1956)

Before BORAH, TUTTLE and JONES, Circuit Judges.

TUTTLE, Circuit Judge.

This is a petition for review of a decision by the Tax Court disallowing a deduction in 1946 of an item of $13,300, representing a reserve set up by taxpayers while keeping their books on the accrual basis, to represent their estimated cost of carrying out a guarantee, given with each of the furnaces sold by them during the year, to turn the furnace on and off each year for five years.

The opinion of the Tax Court treats the matter as though ample proof was offered by the taxpayer (hereafter the husband will be called "taxpayer") to raise the legal issue and we find the record warrants this treatment. Taxpayer was in the gas furnace business in 1946, during which he sold 665 furnaces, each with a guarantee that he would turn the furnace on and off each year for five years. The fact that such service, if performed, would cost $2.00 per call was amply established. The taxpayer, himself a bookkeeper and accountant prior to entering this business, testified to his keeping his books on the accrual method and claimed that the only way his income could be accurately reported was by charging against the cost of furnaces sold in 1946 the reserve representing the amount which he became legally liable to expend in subsequent years in connection with the sales. The proof was clear that he actually sold the furnaces for $20.00 to $25.00 more than his competitors because of his guarantee, which they did not give.

We think it quite clear that petitioner's method of accounting comes much closer to giving a correct picture of his income than would a system in which he sold equipment in one year and received an inflated price because he obligated himself, in effect, to refund part of it in services later but was required to report the total receipts as income on the high level of the sales year and take deductions on the low level of the service years. The reasonableness of taxpayer's action, however, is not the test if it runs counter to requirements of the statute. We find that not only does it not offend any statutory requirement, but, in fact, we think it is in accord with the language and intent of the law. Clearly what is sought by this statute [§446(a) and (b)] is an accounting method that most acccurately reflects the taxpayer's income on an annual accounting basis.

The decisions of the Tax Court and of the several Courts of Appeals are not uniform on this subject, some circuits requiring a mathematical certainty as to the exact amount of the future expenditures that cannot be satisfied in the usual case. Other circuits, seemingly more concerned with the underlying principle of

charging to each year's income reasonably ascertainable future expenses necessary to earn or retain the income, have permitted the accrual of restricted items of future expenses. Two of this latter category are Harrold v. Commissioner, 192 F.2d 1002 (4th Cir. 1951), and Pacific Grape Products Co. v. Commissioner, 219 F.2d 862 (9th Cir. 1955).

In the *Harrold* case the taxpayer was permitted to deduct from its gross income in 1945 the estimated cost of back filling a tract of land which would be done under state law requirements in the year 1946. The Court there said:

> . . . when all the facts have occurred which determine that the taxpayer has incurred a liability in the tax year, and neither the fact nor the amount of the liability is contested, and the amount, although not definitely ascertained, is susceptible of estimate with reasonable accuracy in the tax year, deduction thereof from income may be taken by a taxpayer on an accrual basis (192 F.2d 1002, 1006.)

The *Pacific Grape Products* case is also, it seems to us, indistinguishable in principle from the case before us. There the taxpayer accrued the sales price of canned goods sold on December 31, and at the same time deducted the estimated cost of labeling and preparing the goods for shipping and brokerage fees to be paid the following year. The Tax Court, with six judges dissenting, accepted the Commissioner's view that the deductions should be disallowed. 17 T.C. 1097. The Court of Appeals reversed, saying:

> Not only do we have here a system of accounting which for years has been adopted and carried into effect by substantially all members of a large industry, but the system is one which appeals to us as so much in line with plain common sense that we are at a loss to understand what could have prompted the Commissioner to disapprove it. Contrary to his suggestion that petitioner's method did not reflect its true income it seems to us that the alterations demanded by the Commissioner would wholly distort that income.

The case of Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955), is considered by both parties here and was noted by the Tax Court as of especial significance. That case involved the treatment of prepaid income received by the Beacon Publishing Co. covering subscriptions to be furnished in subsequent years. The Tax Court in its decision here said:

> . . . This is essentially the same problem as the reporting of prepaid income in the year in which received for services to be performed in following years. The petitioner in fact, on brief, recognizes that the two problems are identical and cites Beacon Publishing Co. v. Commissioner, 10 Cir., 1955, 218 F.2d 697, in support of his argument that the reserve here in issue was a proper deduction in computing his income in 1946.

The Tax Court then simply declined to follow the Court in the *Beacon* case, preferring to adhere to its own views as expressed in Andrews v. Commissioner, 23 T.C. 1026. We prefer the reasoning as well as the conclusion reached by the Court in the Tenth Circuit. There the opinion correctly, we think, disposed of the "claim of right" theory advanced by the Commissioner and adopted by the Tax Court in this type of case.

Finally we think the enactment in 1954 of Section 462 of the Internal Revenue Code of 1954 and its subsequent repeal constitute no legislative history bearing on the construction of the provisions of the Internal Revenue Code of 1939.

The record below amply supports the contention of the taxpayer that there was a legal liability created in 1946, when the purchase price was paid for the gas furnaces, for the taxpayer to turn the furnaces on and off for the succeeding five years; that the cost of such service was reasonably established at a minimum of $2.00 per visit; and that the payment of $20.00 to $25.00 extra by the purchasers fully proved their intention to call upon the taxpayer each year for the

service. These facts authorized the setting up of a reserve out of the 1946 income to enable the taxpayer to meet these established charges in future years. The decision of the Tax Court is therefore in error and must be reversed.

Reversed with directions to enter judgment for the taxpayer.

NOTE

1. *Reserves for estimated expenses.* When a deduction for estimated expenses is denied, it is customary for the courts to rely on Brown v. Helvering, 291 U.S. 193 (1934), which involved a general insurance agent who was entitled to receive commissions on all insurance policies written by its sub-agents. The commissions were reported in the year the policies were written, and a deduction (estimated on the basis of past years) was taken for the commissions that, on the basis of experience, would probably have to be refunded to the companies in the event that some of the policies were canceled by the holders. The Supreme Court denied the deduction:

> In respect to no particular policy written within the year could it be known that it would be cancelled in a future year. Nor could it be known that a definite percentage of all the policies will be cancelled in the future years. Experience taught that there is a strong probability that many of the policies written during the taxable year will be so cancelled. But experience taught also that we are not dealing here with certainties. This is shown by the variations in the percentages in the several five-year periods of the aggregate of refunds to the aggregate of overriding commissions. [291 U.S. at 201.]

During the 1950's, the courts seemed disposed to find that Brown v. Helvering was not controlling in an increasing number of situations, of which *Schuessler* and *Beacon Publishing Co.* are examples. As to their present status, the Supreme Court in *Automobile Club of Michigan* said this in a footnote:

> Beacon Publishing Co. v. Commissioner, 218 F.2d 697, and Schuessler v. Commissioner, 230 F.2d 722, are distinguishable on their facts. In *Beacon,* performance of the subscription, in most instances, was, in part, necessarily deferred until the publication dates after the tax year. In *Schuessler,* performance of the service agreement required the taxpayer to furnish services at specified times in years subsequent to the tax year. In this case, substantially all services are performed only upon a member's demand and the taxpayer's performance was not related to fixed dates after the tax year. We express no opinion upon the correctness of the decisions in *Beacon* or *Schuessler.* [353 U.S. 180, 189 (1957).]

In American Automobile Assn. v. United States, the Court again mentioned the *Beacon* and *Schuessler* cases, saying that they "may be distinguished from the present case on the same grounds which made them distinguishable in Automobile Club of Michigan v. Commissioner."

On the same day that it decided the *AAA* case, the Supreme Court vacated a judgment in favor of the taxpayer in a case involving deductions by a public bus transportation company for its estimated liability on unsettled tort claims, and remanded the case "in light of American Automobile Association v. United States . . . and United States v. Consolidated Edison Co. [holding that an accrual basis taxpayer may not deduct amounts paid under protest in respect of disputed real estate taxes, see page 846 infra]." Milwaukee & Suburban Transport Corp. v. Commissioner, 366 U.S. 965 (1961). On remand (293 F.2d 628), the Court of Appeals affirmed the original pro-government decision in the Tax Court, citing without discussion the same cases cited by the Supreme Court. Certiorari was denied, 368 U.S. 976.

The Tax Court has expressed its view of the status of deductions for estimated expenses, in the light of the preceding cases, as follows:

> This is another of the plethora of cases coming before the courts in recent years involving the deferral of income or the accrual of expenses to cover the estimated cost

of rendering services in the future. We think the issue here is controlled by the recent decisions of the Supreme Court in Schlude v. Commissioner, 372 U.S. 128 (1963), American Automobile Assn. v. United States, 367 U.S. 687 (1961), and Commissioner v. Milwaukee & Suburban Transport Corp., 367 U.S. 906 (1961), which require a decision against the taxpayer herein. While it is true that the *Schlude* and *American Automobile* cases were concerned with the deferral of income rather than the deduction of estimated future expenses, the Court remanded the *Milwaukee & Suburban Transport* case, which did involve the deductibility of estimated expenses, "in the light" of the *American Automobile* case, and on remand the Court of Appeals for the Seventh Circuit vacated its prior decision permitting the deduction of anticipated damage claims and reinstated the decision of this Court denying such deduction on the authority of the *American Automobile* case. See Milwaukee & Suburban Transport Corporation v. Commissioner, 293 F.2d 628 (C.A.7, 1961). While it can be argued that there are technical distinctions in deferring prepaid income and deducting estimated future expenses in cases like this the net result is the same and we think the same principles of tax accounting and the Commissioner's authority should be applied to both techniques. As said in American Automobile Assn. v. United States, supra, the prepaid dues were credited to a reserve "as deferred or unearned income reflecting an estimated future service expense to members." . . .

Petitioner's reliance on such cases as Schuessler v. Commissioner, 230 F.2d 722 (C.A.5, 1956), reversing 24 T.C. 247 (1955), Pacific Grape Prod. Co. v. Commissioner, 219 F.2d 862 (C.A.9, 1955), reversing 17 T.C. 1097 (1952), and Denise Coal Co. v. Commissioner, 271 F.2d 930 (C.A.3, 1959), affirming in part and reversing in part 29 T.C. 528 (1957), is misplaced. Whether or not those cases are all distinguishable from the *American Automobile* and *Schlude* cases, they are all distinguishable from this case. In each of those cases the "operative facts" which gave rise to the future expenses had occurred in the year of accrual; in *Schuessler* the furnaces had been installed and there was a fixed obligation to turn them on and off; in *Pacific Grape Products* the fruit had been sold and there was a fixed obligation to pack and ship the merchandise to the customers; and in *Denise* the land had been stripped and there was a statutory obligation to rehabilitate the land. But here, as in the automobile club cases and the *Schlude* case, the operative facts which gave rise to the obligation, i.e., the demands by the subscribers for the service, had not occurred in the years of accrual. Where the operative facts giving rise to the future expenses have not occurred in the year of accrual, the estimated expenses cannot be deducted even though they can be estimated with reasonable certainty and even though prudent business requires that a reserve be set up. Brown v. Helvering, 291 U.S. 193 (1934). [Simplified Tax Records, Inc. v. Commissioner, 41 T.C. No. 9 (1963).]

2. *Vacation pay.* In I.T. 3956, 1949-1 C.B. 78, the Internal Revenue Service ruled that a taxpayer on the accrual basis could deduct its liability for vacation pay under a contract providing that any employee who worked 160 days during the year would get vacation pay in the following year, unless he left the employer's employ (except for illness, disability, furlough, or temporary lay-off) before the scheduled vacation period:

> After the end of a taxable year, the liability for vacations with pay (or pay in lieu thereof) may, with respect to some employees, be terminated if the employment relation is terminated prior to the scheduled vacation period. This circumstance, however, will not preclude the accrual of vacation pay at the end of the taxable year in which the services are performed, since, with respect to the individual employee at the end of such year, the employer would be justified in anticipating that the liability will be paid . . . or, with respect to the employees as a group, such circumstance would only make uncertain the ultimate amount of liability to the group.

After similar accruals were denied by several courts, however, see Seldon v. Commissioner, 214 F.2d 655 (6th Cir. 1954), the Internal Revenue Service repealed I.T. 3956, announcing that "no accrual of vacation pay can take place until the fact of liability to a specific person has been clearly established and the amount of the liability to each indi-

vidual is capable of computation with reasonable accuracy." Rev. Rul. 54-608, 1955-2 C.B. 8.

The effective date of Rev. Rul. 54-608 was postponed from time to time, initially by the Internal Revenue Service and later by legislation; under Public Law 88-153, 77 Stat. 272, its effective date was postponed to January 1, 1965, "so Congress will have an opportunity to consider the problem of the deduction of accrued vacation pay and other similar accrual-type deductions prior to the application of this Revenue Ruling 54-608 which provides stringent rules in this area." S. Rept. No. 488, 88th Cong., 1st Sess. See also Denver & Rio Grande Western Railroad Co. v. Commissioner, 38 T.C. 557, 570-576 (1962).

3. *Trading stamps.* A long-standing regulation, Regs. §1.451-4, permits taxpayers who issue trading stamps or coupons redeemable for merchandise to deduct an amount that, in the light of experience, will be required to redeem the stamps or coupons. Grolier Society, Inc. v. Commissioner, ¶53,304 P-H Memo T.C., involved a taxpayer who sold encyclopedias and issued to each buyer 100 coupons, each entitling the buyer to submit a question for research and reply. The court implied that the estimated cost of answering these questions could be accrued under the regulation dealing with trading stamps, but denied the deduction because the information called for by the regulation was not supplied.

4. *References.* Schapiro, Tax Accounting for Prepaid Income and Reserves for Future Expenses, 12 Tax Executive 105 (1960); Loeb, Cash Receipts by Accrual Method Taxpayers: The American Automobile Association Case, 1960 Tulane Tax Inst. 737; Behren, Prepaid Income — Accounting Concepts and the Tax Law, 15 Tax L. Rev. 343 (1960); Austin, Surrey, Warren and Winokur, The Internal Revenue Code of 1954: Tax Accounting, 68 Harv. L. Rev. 257 (1954).

4. *The Use of Inventories*

Sections 471 and 472 of the 1954 Code, relating to the use of inventories, are derived, without substantive change, from §22(c) and (d) of the 1939 Code.

HOUSE DOCUMENT NO. 140
STATEMENT OF SECRETARY DILLON Re PRESIDENT'S TAX MESSAGE of APRIL 20, 1961

House Ways and Means Committee, 87th Cong., 1st Sess. (1961)

The President has directed the Internal Revenue Service to give increasing attention to inventory reporting as an area of tax avoidance, and to step up emphasis on both the verification of the amounts reported as inventories and the examination of methods used in arriving at their reported valuation.

The taxable income of a business is understated whenever the inventory at the end of the year is understated. The cost of goods sold deduction allowed is computed by adding to the beginning inventory the purchases for the year and subtracting from this total the ending inventory. For example the cost of goods sold might be as follows:

Beginning inventory	$ 40,000
Purchases during year	200,000
Total	$240,000
Ending inventory	60,000
Cost of goods sold	$180,000

If, however, the taxpayer in the above example reports that his ending inventory was only $50,000, the cost of goods sold deduction would become $190,000, result-

ing in an understatement of taxable income of $10,000. The computation of cost of goods sold and the understatement of it would be as follows:

Beginning inventory	$ 40,000
Purchases during year	200,000
Total	$240,000
Ending inventory	50,000
Cost of goods sold deduction	$190,000
Actual cost of goods sold	$180,000
Understatement of income	$ 10,000

To the extent that an understatement of the ending inventory continues in future years, the taxpayer will not have paid tax on the full amount of his income. At the minimum, the result is deferral of the time of paying the tax. In some cases, as the result of losses, sale of the business, or death of the taxpayer, this income may escape taxation entirely.

Understatement of the ending inventory may be accomplished by manipulation of the code provision permitting inventories to be valued at cost or market, whichever is lower.* The use of very low market values, of course, reduces the amount of the ending inventory, thereby reducing taxable income. In addition, the amount of the ending inventory may be understated by not including therein a proper count of all inventory items.

In order to assist in correcting abuses in the inventory area, taxpayers might be required to report in the tax return the cost of the closing inventory before any reductions to market. The taxpayer would then separately state the amount of any inventory valuation deduction. If market values are used for any items of inventory, the taxpayer would be required to explain on what basis the market value was determined and the relationship of recent purchases and sales to that market value. In addition, taxpayers might be required to state whether and by whom a physical count of the inventory was taken, whether such inventory was taken by management alone or by a certified public accountant, and the procedures followed to insure that all items of inventory were correctly counted.

Legislation is not needed to carry out the recommendation of the President in this area, since the above reporting requirements can be effected by administrative action including changes in the data required to be included on tax returns.

NOTE

1. *"Lower of cost or market."* For an extended discussion of the taxpayer's option to value inventories at lower of cost or market, rather than at cost, see Space Controls, Inc. v. Commissioner, 322 F.2d 144 (5th Cir. 1963).

2. *References.* Schwaigart, Increasing IRS Emphasis on Inventories Stresses Need for Proper Practices, 19 J. Taxation 66 (1963); Comment, Inventory Problems Under the Federal Income Tax, 44 Marq. L. Rev. 335 (1960-1961); Graves, Tax and Financial Considerations Affecting the Choice of Inventory Systems, 1959 Tulane Tax Inst. 390; Graichen, Undervaluation of Inventories — Tax and Accounting Problems: Implications of Sections 481 and 1311-1315, 20 N.Y.U. Inst. on Fed. Taxation 423 (1962).

For more general discussions of the relationship between taxation and inventories, see Butters, Effects of Taxation: Inventory Accounting and Policies (1949); Jensen, Statement Before House Ways and Means Committee, 83d Cong., 1st Sess., Hearings on General

* Regs. §1.471-2(c). — Ed.

Revenue Revision 607-610 (1953); Eldridge, Issues Raised by Proposal to Grant Cost or Market Option with LIFO, 6 Nat. Tax J. 52 (1953).

5. *Installment and Deferred Payment Sales*

Section 453 of the 1954 Code, relating to installment sales, is derived, with minor substantive changes, from §44 of the 1939 Code.

REV. RUL. 234
1953-2 C.B. 29

Advice is requested regarding the Federal income tax consequences of an agreement between a publisher and a taxpayer,* who is not an author by profession, for the preparation and delivery of a literary composition by the taxpayer under the conditions described below.

The agreement between the taxpayer-author and the publisher in the instant case provides that the author will complete and deliver within a certain period of time a final manuscript of a literary composition, together with suitable material from which illustrations can be made. Simultaneously with the delivery of such manuscript and materials, the author has agreed to grant and assign to the publisher all rights of every kind in and to the composition, including the right to obtain statutory copyrights thereof and renewals or extensions of such copyrights in the name of the publisher. The agreement indicates the minimum and maximum number of words desired for the composition and the general subject to be covered thereby. The author represents and warrants that he will be the author and sole proprietor of the composition, that the composition will not have been previously published, and that it will not contain libelous or otherwise unlawful material.

The agreement also provides that the price to be paid for the rights in and to the composition is 120*x* dollars. On the date the manuscript is delivered, the purchaser will pay 20*x* dollars to the author and deliver to him four noninterest bearing promissory notes of 25*x* dollars each, maturing in each of 4 succeeding years. The agreement specifically provides that the author shall be an independent contractor and shall not act as the agent of the publisher. It also includes certain elections which permit the publisher to terminate the agreement in the event of a breach of contract by the author or his inability to complete the composition because of death or other disability. The author agrees not to make or permit the publication of any material, which may be considered to be in any material way in competition with his composition, until the expiration of a certain period of time after publication by the publisher.

At the time the contract was entered into, the author received a loan of 10*x* dollars from the publisher. This loan is to be repaid to the publisher on or before a fixed date which is prior to the date of delivery of the manuscript except that in the event of death or incapacity, repayment will be made only under certain specified conditions relating to the receipt of proceeds by the author or his estate from the subject matter of the literary composition.

The primary question to be determined is whether, under the terms of the agreement between the publisher and the author, the transaction constitutes a casual sale of personal property which may be returned on the installment basis under the provisions of [§453(b)].

* Former President Harry S. Truman. — Ed.

A literary composition is recognized as property in the Internal Revenue Code. See [§1221]. Such property is considered to be personal property. G.C.M. 236, C.B. VI-2, 27 (1927); I.T. 2735, C.B. XII-2, 131 (1933).

Under the provisions of [§453(b)] of the Internal Revenue Code, in the case of casual sales of personal property, if the selling price exceeds $1,000, and the initial payments received in cash or other property, other than evidences of indebtedness of the purchaser, during the taxable period of the sale, do not exceed 30 percent of the selling price, the gain realized from such sale may be reported on the installment basis.

Under the installment basis, there is reportable as income in any taxable year only that proportion of the installment payments actually received in that year which the gross profit realized or to be realized when payment is completed, bears to the total contract price. . . .

An executory contract to sell is to be distinguished from a sale of property. In the case of Dahlinger v. Commissioner, 51 Fed. (2d) 662, certiorari denied, 284 U.S. 673, involving the question of the year in which a sale was consummated, the United States Circuit Court of Appeals for the Third Circuit in affirming the decision of the Board of Tax Appeals, 20 B.T.A. 176, referred to the following statements applied by the Board of Tax Appeals to show the distinction between a contract to sell and a sale:

> A contract to sell goods is a contract whereby the seller agrees to transfer the property in goods to the buyer for a consideration called the price.
>
> A sale of goods is an agreement whereby the seller transfers the property in goods to the buyer for a consideration called the price. (Williston on Sales, vol. 1, sec. 1.)

Williston proceeds as follows:

> The distinction is often expressed by the terms "executory" and "executed" sales. Whether a bargain between parties is a contract to sell or an actual sale depends upon whether the property in the goods is transferred. If it is transferred, there is a sale, an executed sale, even though the price be not paid.

Based upon the above facts, it is held, as follows:

(1) The agreement entered into by and between the author and the publisher constitutes an executory contract to sell a manuscript at a future date. A sale of the manuscript will occur on the date the manuscript is delivered and assigned to the publisher by the author. Such sale will qualify as a casual sale of personalty on the installment basis within the purview of [§453(b)] of the Code.

(2) Except as provided in paragraph 3, below, the loan of 10*x* dollars received by the author on the effective date of the agreement will not be subject to Federal income tax.

(3) The loan received by the author and not theretofore repaid, will be includible in the author's gross income as ordinary income in the taxable year in which the agreement is terminated if the author fails to complete and deliver the manuscript on or before the agreed date by reason of his death or disability, and if the publisher elects to terminate the agreement, except that if such termination occurs after the death of the taxpayer the amount of the loan shall be includible in the gross income of the taxpayer's estate as ordinary income.

(4) The [taxable portion of the] payment of 20*x* dollars received by the author pursuant to the agreement upon the delivery and assignment of the manuscript . . . computed in accordance with the provisions of [§453(a)] of the Code, will be includible in gross income as ordinary income in the taxable year in which the manuscript is delivered and assigned to the publisher. The loan of 10*x* dollars which the publisher made to the author is not considered to be [a "payment"]

for the reason that, on the basis of the facts represented, it is determined to constitute a loan rather than an advance. The repayment thereof is independent of the delivery of the manuscript, for which a separate date was provided, and the loan is required to be repaid whether or not the manuscript is delivered. The only condition under which repayment is not required is the death or other disability of the author prior to delivery of the manuscript, but even in such case the manuscript, or, if not completed, the author's working papers with respect thereto, will serve as security for the loan since the author or, in the event of his death, his estate is required to repay the portion of the loan represented by any proceeds received from the subject matter of the composition involved.

(5) The promissory notes delivered to the author pursuant to the agreement upon the delivery of the manuscript will be "installment obligations," within the meaning of [§453(d)] of the Code.

(6) The taxable portion of payments received by the author in full satisfaction of the promissory notes so delivered to him, as computed in accordance with the provisions of [§453(a)] of the Code, will be includible in gross income as ordinary income in the taxable year in which such payments are received.

(7) If any of such promissory notes so delivered to the author are satisfied at other than face value or are sold or exchanged, the excess of the amount realized over the basis of such note will constitute ordinary income computable under the provisions of [§453(d)] of the Code, in the taxable year in which such amounts are realized.

(8) If any of such promissory notes so delivered to the author are distributed, transmitted, or disposed of otherwise than by sale or exchange, the excess of the fair market value of such note as of the time of such distribution, transmission, or disposition, over its basis, will constitute ordinary income computable under the provisions of [§453(d)] of the Code, in the taxable year in which such distribution, transmission, or disposition occurs. [In the case of a transmission of installment obligations at death, see §453(d)(3), enacted in 1954.]

(9) The cost of producing the manuscript will constitute the basis thereof for the purpose of computing the gain realized from the sale.

NOTE

1. *Installment sales by dealers.* Under §453(a), persons who regularly sell personal property on the installment plan may elect to report their profits as the payments come in, even though the property is included in inventory or sells for less than $1000 and even though the initial payments exceed 30 per cent of the sales price. But a dealer who elects to report income on the installment basis must do so for all installment sales during the year, while in the case of a "casual" sale of personal property the taxpayer has a separate option with respect to each transaction. For an interpretation of the phrase, "a person who regularly sells . . . on the installment plan," see Davenport Machine & Foundry Co. v. Commissioner, 18 T.C. 39 (1952); Consolidated Dry Goods Co. v. United States, 180 F. Supp. 878 (D. Mass. 1960) (non-acquiescence, 1960-2 C.B. 163); see also §453(e) ("revolving credit" plan qualifies for installment sale provisions).

For the problems of a dealer who switches to the installment method, see City Stores Co. v. Smith, 154 F. Supp. 348 (E.D. Pa. 1957); DeWind and Rubenstein, Tax Problems of Expanding Businesses, 1960 Tulane Tax Inst. 144.

2. *Real estate.* Note that the installment basis may also be elected for real estate, by both dealers and non-dealers, so long as the payments in the year of sale do not exceed 30 per cent of the selling price.

3. *Losses on installment sales.* Section 453(b)(1) provides that in the case of a sale that satisfies its requirements the income "may . . . be returned on the basis and in the manner prescribed in subsection (a)," i.e., income is to be reported on each installment payment in the same proportion "which the gross profit, realized or to be realized when pay-

ment is completed, bears to the total contract price." It has been held that this does not permit a loss on the sale to be spread over the payment period. Martin v. Commissioner, 61 F.2d 942 (2d Cir. 1932).

4. *References.* Lanahan, Taxation of Installment and Deferred Payment Sales, 1960 Tulane Tax Inst. 618; Anderson, The Taxation of Installment Sales Including Section 44(d) Problems, 1953 So. Calif. Tax Inst. 341; Sanders, Disposition of Installment Obligations, 1957 id. 755; Raum, The Tax Aspects of Revolving Credit: Application of the Installment Method of Reporting Income, 19 N.Y.U. Inst. on Fed. Taxation 1225 (1961).

ENNIS v. COMMISSIONER

17 T.C. 465 (1951) *

ARUNDELL, Judge: Respondent has increased petitioner's income for the calendar year 1945 by the sum of $10,871.33 on the ground that the petitioner, who reported her income on the cash receipts method, was required under [§§451(a), 1001(a) and 1001(b)], to include in her 1954 income the full amount of her one-half interest in the profit realized from the sale of the Deer Head Inn. . . . Respondent contends that since the sale is a completed transaction in 1945 the entire profit on the sale is taxable in that year.

We agree that in every practical way the sale was complete in 1945. In that year the vendee went into possession of the property and at the same time assumed all the burdens and benefits of ownership. The purchase price was definitely fixed and the vendee was under an unconditional obligation to pay it under the terms set forth in the contract. Nibley-Mimnaugh Lumber Co., 26 B.T.A. 978, affd. 70 F.2d 843; Union Pacific Railroad Co., 32 B.T.A. 383, affd. 86 F.2d 637.

It does not follow, however, that the entire purchase price in excess of the basis constituted gain taxable in the year 1945. Since petitioner reported her income on the cash receipts and disbursements basis she realized a gain from the sale of property only to the extent that the "amount realized" therefrom is in excess of her basis. [§1001(b)] of the Internal Revenue Code provides that the "amount realized" shall be "any money received plus the fair market value of the property (other than money) received."

Upon the sale petitioner received as a down payment a sum of cash not in excess of her basis for the property, plus the vendee's contractual obligation to pay the balance of the purchase price in deferred payments extending beyond the year in question. This contractual obligation cannot be considered an "amount realized" unless it is the equivalent of cash. In John B. Atkins, 9 B.T.A. 140, we stated: ". . . in the case of one reporting income on the cash receipts and disbursements basis only cash or its equivalent constitutes income." This basic rule has been consistently followed. . . .

In determining what obligations are the "equivalent of cash" the requirement has always been that the obligation, like money, be freely and easily negotiable so that it readily passes from hand to hand in commerce. See Dudley T. Humphrey, 32 B.T.A. 380, wherein we held that non-negotiable promissory notes are not the equivalent of cash and cf. S. L. Meyer, Executor, 23 B.T.A. 1201; Harold W. Johnston, 14 T.C. 560; C. W. Titus, 33 B.T.A. 928; Perry v. Commissioner, 152 F.2d 183. This principle was recently reiterated in the *Johnston* case wherein we held that a cash basis taxpayer realizes no income when he receives upon the sale of property a promise to pay contained in a contract of sale that

> merely requires future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce, which could be recognized as the equivalent of cash to some extent, are given and accepted as part of the purchase price.

* See also Ennis' Estate v. Commissioner, 23 T.C. 801 (1955).

In the case before us the promise to pay was merely contractual; it was not embodied in a note or other evidence of indebtedness possessing the element of negotiability and freely transferable. It is true that the contract possessed many elements of a mortgage, Corpus Juris, vol. 66, sec. 1080, p. 128; Tiffany, Real Property, 3d ed., vol. 1, sec. 308, p. 535; . . . but this characteristic does not lend to the contract the necessary element of negotiability. Cf. Bernard Realty Co. v. United States, 188 F.2d 861.

We conclude, therefore, that the contractual obligation was not the "equivalent of cash," and the only "amount realized" by petitioner on the sale of the property in 1945 was the sum of cash received. Since this sum was not in excess of petitioner's basis for that property no gain was realized on the sale in 1945.

Reviewed by the Court.

Decision will be entered under Rule 50.

TURNER, J., dissenting: I am unable to reconcile the conclusions reached in this case with the contrary ruling which has long been settled law in cases where a vendor of real estate, in addition to the simple individual liability to pay, receives as further security a mortgage on the property sold. While there are form and technical differences in the two types of transactions, they are for practical purposes substantially similar. In each instance, the vendee is regarded as the owner of the real estate, and in each instance, the land may be sold, devised, or encumbered by him, and on his death descends to his heirs subject only to the mortgage or land contract. In the case of land contracts, see on this point Bowen v. Lansing, 219 Mich. 117, 88 N.W. 384. The purpose of both the land contract and the mortgage is to secure payment of the balance remaining of the simple or personal obligation to pay. For a land contract case, see Walker v. Casgrain, 101 Mich. 604, 60 N.W. 291. It is true that in the land contract cases there is no transfer of legal title until full payment is made, but the vendor holds legal title in trust for the purchaser pending such full payment. . . . For other cases which seem to establish the similarity in over-all effect between mortgages and land contracts, see Harold R. Smith, 39 B.T.A. 892. . . . And finally, both mortgages and land contracts are regularly sold, traded and assigned. Probably the most noticeable difference between the two is geographic. In Michigan, for instance, the use of the land contract, rather than the mortgage, appears to be the method commonly followed in making real estate sales. We should where possible avoid one rule of law for one part of the country and a different rule for other sections.

Harold W. Johnston, supra, relied on by the Court herein, is in my opinion an entirely different case. There the property sold was corporate stock and the selling price had not even been and could not be fixed and determined in 1942, the taxable year. Furthermore, the discussion therein as to property received would, it seems to me, bring this case more nearly in line with the land mortgage cases than otherwise.

OPPER, J., agrees with this dissent.

C. W. TITUS, INC. v. COMMISSIONER

33 B.T.A. 928 (1936)

TRAMMELL: This case has been reconsidered in so far as it relates to the taxable gain for 1926 derived from the sale of oil and gas leases in that year. After reconsideration we think that we were in error.

The petitioner entered into a contract in writing with the Tidal Oil Co. on February 27, 1926, the pertinent portions of which are as follows:

THEREFORE, for and in consideration of the sum of one dollar ($1.00) and other good and valuable considerations in hand paid by second party (Tidal Oil Co.), the receipt

whereof is hereby acknowledged by first party, and the mutual covenants and agreements hereinafter contained, IT IS UNDERSTOOD AND AGREED by and between the parties hereto as follows: . . .

Upon the approval of said titles and the execution and delivery to second party of the assignments, conveyances, orders and other papers referred to in the preceding paragraph, second party will pay to first party, as consideration for said properties, the sum of two million dollars ($2,000,000), payable as follows:

$500,000.00, in cash, upon the approval of titles and delivery of the papers above referred to;
$500,000.00 on or before September 1, 1926;
$500,000.00 on or before March 1, 1927; and
$500,000.00 on or before September 1, 1927.

Titus agreed to furnish abstracts to the property described in Exhibits A, B, C, and D, that is, the leases, within 10 days from the date of the contract. Upon approval of titles by the attorneys for the Tidal Oil Co., Titus was to immediately execute and deliver proper assignments, together with orders on the pipe line companies which might have been running the oil from said properties, and such orders and other papers as might be required or might be necessary in order to obtain the approval of the Secretary of the Interior of the assignments covering the oil leases from the Osage Indian Tribe, and when these things had been done the purchaser agreed to make the payments. . . .

In the previous opinion [32 B.T.A. 1222] we held that a taxpayer keeping its books and records on the accrual basis is required to report the income represented by the deferred payments, regardless of the fair market value of the deferred payments. We also held that the petitioner had failed to show that the obligations in controversy had no fair market value or a fair market value less than the amount of the face thereof. We now think that we were in error in holding that the fact that the taxpayer kept its books on the accrual method of accounting was determinative of the issue, and also think we were in error in holding that there was no evidence that the deferred payments did not have a fair market value.

The regulations of the Commissioner, approved by the Secretary, under the Revenue Act of 1921 and all subsequent revenue acts have provided in the case of the sale of real estate on a deferred payment plan, not on the installment basis, where the obligations received by the vendor have no fair market value, that the payments in cash or other property having a fair market value shall be applied against and reduce the basis of the property sold and any excess of such basis shall be taxable to the extent of the excess, and that gain or loss is realized when the obligations are disposed of or satisfied, the amount being the difference between the reduced basis above mentioned and the amount realized therefor. [Regs. §1.453-6.] . . .

The Board has decided many cases of deferred payment sales of realty and casual sales of personal property without considering on what method the taxpayer kept its books. . . .

In view of the foregoing, it is our opinion that a taxpayer which keeps its books generally upon the accrual basis has the right to report and have its income computed upon the basis of the deferred payment plan not on the installment basis as provided in the regulations. In this case the respondent has raised no question as to this. The only real question is whether the deferred payments had a fair market value. The Commissioner contends that they did have. The question of the accrual basis was interjected by the Board and we now think that we were in error in doing so. . . .

In the case at bar the only instrument in writing evidencing the fact that the future payments were to be made was the executory or preliminary contract, for

the making of which the purchaser did not pay anything, and the obligation to make any payments did not arise until later during the taxable year when the petitioner had carried out the terms thereof. . . .

In the case of Charles C. Ruprecht, 16 B.T.A. 919, we held as follows:

> We do not consider, however, that the respondent's views with respect to the deferred payments are correct, for the reason that the obligation of the Standard Oil Co. to pay was not so evidenced that it could have been converted into cash, the only record thereof being in the deed of conveyance signed by the grantors. . . . In short, the obligation of the Standard Oil Co. amounted to nothing more than a mere noninterest-bearing account receivable.

We held in that case that the deferred payments to be made by the Standard Oil Co. did not have a fair market value and the Court of Appeals, in 49 Fed. (2d) 458, affirmed our decision. . . .

In the case of Beddell v. Commissioner, 30 Fed.(2d) 622, the court said:

> But if land or a chattel is sold, and title passes merely upon a promise to pay money at some future date, to speak of the promise as property exchanged for the title appears to us a strained use of language, when calculating profits under the income tax. Section 102(b) of the Act of 1918 provided for an exchange of property and made the profit depend upon "the amount of its (the property received) fair market value, if any" — a phrase which was amended in the law of 1921 . . . to "readily realizable market value." There is a difference between the two, but it is absurd to speak of a promise to pay a sum in the future as having a "market value," fair or unfair. Such rights are sold, if at all, only by seeking out a purchaser and higgling with him on the basis of the particular transaction. Even if we could treat the case as an exchange of property, the profit would be realized only when the promise was performed. . . .

. . .

In the case of Dudley T. Humphrey, 32 B.T.A. 280, there was evidence that the nonnegotiable promissory notes did not have a fair market value. This evidence consisted of the testimony of the petitioner, himself, to the effect that the notes received were nonnegotiable and, being nonnegotiable, did not have any fair market value. On the other hand, financial statements were introduced showing that the purchaser, that is, the maker of the notes, had net assets in excess of the amount of the notes even by using the book values of the securities owned by the purchaser, which had greatly increased in value. The basic evidence in the case as to the fair market value of the notes consisted of the fact that the notes were nonnegotiable, and, being so, had no fair market value. We said "A mere promise to pay in the future which is not accepted in payment, but only as an evidence of indebtedness, is not ordinarily the equivalent of cash," and the *Bedell* case supra, was cited and relied on. Here the contract itself obviously only represented the evidence of the indebtedness and was not, itself, accepted in payment for the property.

In none of the foregoing cases was there any evidence introduced directed to the question of the fair market value of the promise to pay, except in the case of Dudley T. Humphrey, supra, discussed above.

In all of the court decisions above discussed the courts took the position that, when evidence was introduced showing that the deferred payments were evidenced only by contract, where no notes, bonds, or other evidences of indebtedness other than the contract were given, such contract had no fair market value, and that the amounts of the deferred payments should be included in income when received. In the *Ruprecht* case, supra, the only evidence of the deferred payments was contained in the deed of conveyance. Based on this finding we held that the deferred payments did not have a fair market value. Our conclusion was based on the

fact that the vendor had nothing that he could take to anyone to sell; he had nothing except an account receivable. In this case, while the petitioner had a written contract, there was nothing in the contract itself to indicate when, if ever, the purchaser would become bound to make the payments. To show that the purchaser had become bound to make the payments would have required extrinsic evidence. There were certain things required to be done by the vendor under the terms of the contract before the delivery of the deed or before the vendor was obligated to accept it. Evidence of delivery and acceptance of the deed was a sine qua non to any liability. When this was established there would have been a prima facie obligation to make the full payment as provided in the contract, yet an assignee would have been entitled to know beyond a prima facie case that all the obligations of the purchaser had definitely arisen, that is, that all titles were good, all transfer orders were made, approval of the Secretary of the Interior secured as to the leases from Indian tribes, and other things required had been done. After the delivery of the deed there was still an accounting to be had between the vendor and vendee for all the oil produced since the execution of the contract, and other adjustments were required. In any event, the petitioner, itself, after the delivery of the deed, was possessed of nothing in writing to show that it had fully complied with the executory or preliminary contract to make it obligatory on the purchaser's part to make the payments, except possibly its books and records, which would show the account receivable, but the record is silent as to whether any liability was ever shown on the books. We think, therefore, that the principle of the *Ruprecht* case, supra, as well as the court decisions and other Board cases herein referred to, are applicable in this case. . . .

In order for the petitioner to be able to convert the promise to pay into cash it would have had to produce and deliver to a purchaser the evidence of liability to pay. Only a conditional or contingent liability is shown by the instrument itself. The real liability in this case could be shown only by oral testimony, and, while we have assumed from the record that the sale was consummated in 1926, there is no direct and conclusive evidence to that effect. An obligation to pay in the future which depends so largely on oral evidence to support it, in our opinion, can not be said to have a fair market value, aside from the reasoning of the courts and the Board as to written contracts, and in this case, even after the sale had been consummated, there was still an accounting to be had for oil produced since the making of the executory or preliminary contract. The purchaser would have had an offset for an undetermined amount after the delivery by petitioner of all papers required to be delivered until such time as petitioner fully settled on the basis of such accounting. This fact, in connection with all the facts and circumstances, convinces us of the lack of any fair market value of the deferred payments.

Upon reconsideration, therefore, it is our opinion that the petitioner had the right to include in its taxable income for 1926 only the cash received. Petitioner had the right to have his tax computed upon the basis of the deferred payment plan, not on the installment basis. We think we were in error in our previous decision and it is, therefore, modified in accordance with the opinion herein.

Judgment will be entered under Rule 50.

NOTE

1. *Titus today.* How does the transaction in *Titus* differ from the ordinary sale on open account, the income from which must be reported by the accrual basis taxpayer when the sale occurs? In Johnston v. Commissioner, 14 T.C. 560 (1950), the court made the following observations about the difference between the cash receipts and disbursements basis and the accrual basis:

An agreement, oral or written, of some kind is essential to a sale. If payment is made at the same time that the obligation to pay arises under the agreement, then the profit would be reported at that time no matter which method was being used. However, the situation is different when the contract merely requires future payments and no notes, mortgages, or other evidence of indebtedness such as commonly change hands in commerce, which could be recognized as the equivalent of cash to some extent, are given and accepted as a part of the purchase price. That kind of a simple contract creates accounts payable by the purchasers and accounts receivable by the sellers which those two taxpayers would accrue if they were using an accrual method of accounting in reporting their income. But such an agreement to pay the balance of the purchase price in the future has no tax significance to either purchaser or seller if he is using a cash system. [14 T.C. at 565.]

Can these remarks be reconciled with the treatment of the taxpayer in the *Titus* case? In Castner v. Commissioner, 30 T.C. 1061 (1958), the court held that *Titus* was in error in permitting an accrual basis taxpayer to report the gain on a casual sale of *personal* property on the "deferred payment plan not on the installment basis" of Regs. §1.453-6. In First Savings & Loan Assn. v. Commissioner, 40 T.C. 474 (1963), the court apparently took the further step of excluding accrual basis taxpayers from the use of Regs. §1.453-6 even for real property on the ground that they must treat the face value of an unconditional right to receive payment as money.

2. *Reference.* Desmond, Sales of Property Under the Deferred-Payment Method, 32 Taxes 40 (1954).

6. *Long-Term Construction Contracts*

ROLNIK, TAX PROBLEMS OF CONSTRUCTION CONTRACTORS *

9 New York University Institute on Federal Taxation 925, 925-929 (1951)

Accounting — General.

For United States income tax purposes, a contractor may report income on all contracts on the cash or accrual basis, although the cash basis is not permitted where it is necessary for the contractor to use inventories. In addition, on *long-term* contracts, the contractor may adopt either the completed contract basis or percentage of completion basis.

Long-term contracts are defined in [Regs. §1.451-3] as "building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted." It must be borne in mind that the fact that a contract extends over two taxable years does not necessarily make it a long-term contract.

The contractor must be consistent in his method of reporting all his long-term contracts. In other words, the election may not be applied to selected long-term contracts, but must be to all. Furthermore, the contractor must keep his books in accordance with the basis adopted.

The election to use either the percentage of completion basis or the completed contract basis must be made at the time of filing the first return of the contractor. Any change in method of reporting income from long-term contracts may be made only after securing the consent of the Commissioner. . . .

Percentage of Completion Basis.

Under the percentage of completion basis, the gross income for any year is determined by apportioning thereto such part of the total contract price as the work

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completed that year bears to the total work to be performed under the contract. The Regulations require that the tax return be accompanied by certificates of architects or engineers showing the percentage of completion.

There should be deducted from the reported gross income, all expenditures made during the taxable year on the contract, account being taken of the materials and supplies on hand at the beginning and end of the taxable period for use in connection with the work performed under the contract but not yet applied.

On final completion of the contract, there will usually be a difference in each year's income due to over- or under-estimating the percentage of completion. Under prior Regulations, if upon completion of a contract it appeared that the taxable net income for any year or years had not been clearly reflected by the percentage of completion method, amended returns were permitted or required. This is no longer in the Regulations.

Completed Contract Basis.

The gross income on the completed contract basis is reported in the taxable year in which the contract is finally completed and accepted. All the costs and expenses applicable to the contract are deferred until the contract is completed. Not only the gain, but the loss is deferred until such time.

Where a contract covers more than one unit, for example a number of ships, the completed contract basis requires that the entire gross income be reported in the year the last unit is completed. If the contractor wishes to report the gross income on each unit as it is completed, he may not use the completed contract basis. A series of independent contracts may not be treated as a single contract.

Where a corporation, on a completed contract basis, is liquidated before the completion of a contract, the profit on the completed portion must be reported in the year of such liquidation, exactly as if the corporation were on the percentage of completion basis.

Importance of Date of Completion.

The date of completion is an important date. In the first place, it determines whether a contract is a long-term contract and, if so, determines whether the contractor may use either the percentage of completion basis or the completed contract basis. In the second place, it determines the year when the income on the completed contract basis is to be reported.

Substantial completion and acceptance is sufficient. Thus, a contract is deemed to be completed and accepted when the architect's certificate authorized final payment and the customer took possession, even though a small amount was withheld by the customer to cover adjustments due to minor defects, and he officially accepted the work in the following year. Where a constructed machine has to be assembled and tested, the date of completion and acceptance is deferred until such time, even though the contractor received payment and shipped the machine in the previous year. The guaranteed period of maintenance by the contractor does not delay the completion date.

Costs and Expenses.

As previously stated, on the percentage of completion basis or completed contract basis, there must be deducted from the gross income reported on a contract in the taxable year all the costs and expenses applicable to the contract gross income of that year. There is usually no problem with regard to the treatment of such overhead items as repairs, depreciation, rentals of equipment, bond premiums, insurance premiums, and casualty and other losses, which are directly applicable to the contract. It is still unsettled whether such items as general and

administrative expenses, interest, and taxes may be deducted in full in the year paid or incurred or be apportioned in part to uncompleted contracts at the end of each year. The Commissioner requires depreciation on items of equipment not used exclusively on any particular contracts, and salaries of officers and employees whose services are not definitely connected with the completion of any particular contracts, to be deducted in the year paid or incurred. However, in a number of cases, taxpayers were permitted to allocate interest, franchise taxes, travel, and office expenses to uncompleted contracts on an approximate estimate basis.

There must be taken into account any materials and supplies charged to the work under the contract but remaining on hand at the end of the year, as well as the value of all unfinished work. Inventories may be valued at cost or market, whichever is lower, as may be elected by the taxpayer, and must be consistently valued. Account must also be taken each year of the deferred charges applicable to future years, for example, unexpired insurance and prepaid rent. . . .

NOTE

References. See Wagman, Tax Accounting for Long-Term Contracts, 33 Taxes 277 (1955); Herwitz, Accounting for Long-Term Construction Contracts: A Lawyer's Approach, 70 Harv. L. Rev. 449 (1957); Note, Deferral of Income Under the Completed Contract Method of Tax Accounting, 64 Yale L.J. 448 (1955).

7. *Changes of Accounting Method*

Section 446(d), requiring the consent of the Treasury if the taxpayer wishes to change his method of accounting, is similar to Regs. 118, §39.41-2(c), 1939 Code.

Section 481, relating to transitional adjustments on a change of accounting method, has no counterpart in the 1939 Code.

PERELMAN v. COMMISSIONER

41 T.C. 243 (1963)

In the latter part of 1950, Howard H. Perelman and others formed a partnership to sell improved real estate. In 1951 and 1952, certain parcels of real estate were sold. In each case, the purchaser made a cash down payment and gave a land contract to evidence the remaining balance of the purchase price. The income from the foregoing sales was reported on the basis that the receipts therefrom did not constitute taxable income until the cost or adjusted basis of the property had first been recovered. For the taxable years 1951 through 1956, petitioners reported their income in the foregoing manner where a sale was made and a land contract was received.

Sometime in 1957, one of respondent's agents began an audit of the taxable years 1953, 1954 and 1955. After the audit, respondent took the position that where there was a sale of property and a land contract was received the gain therefrom should be reported in the year in which the sale was made. It was respondent's position that the contracts had a fair market value equal to their face value and consequently the entire amount of the gain should have been reported in the year in which the sale was made, rather than on a deferred basis. Deficiencies for the foregoing years were agreed to and paid by petitioners. Beginning with the taxable year 1957, petitioners began reporting the entire gain from sales where a land contract was received in the year in which the sale was made.

In 1957 and 1958, petitioners attached statements to their Federal income tax returns stating that they had received proceeds from sales made in 1951 and 1952

but had not included any portion of this income in the current years because the Internal Revenue Service had changed their method of accounting. In the notice of deficiency, respondent determined that petitioners omitted income from the 1951 sale which should have been reported in 1957 and omitted income from the 1952 sales which should have been reported in 1958.*

TRAIN, Judge: . . .

In their petition, petitioners alleged that the gain from the [1951 and 1952 sales] was not includible in their income for the respective years 1957 and 1958 because respondent had changed their method of accounting. On brief petitioners took somewhat of an alternative approach and contended that the gain from the respective properties should have been reported in 1951 and 1952 when the sales were made. Petitioners argue that they received, in the year of sale, cash and property equal to the total sales price of each piece of property and that this amount was in excess of the adjusted basis of each piece of property for determining gain. Therefore, petitioners contend that . . . the gain in question should have been reported in 1951 and 1952 rather than in 1957 and 1958.

Respondent contends that the gain from the three sales in question should be reported in 1957 and 1958 as determined in the notice of deficiency. To support his position, respondent contends that petitioners voluntarily changed their method of accounting in 1957. Respondent contends that from 1951 through 1956 petitioners reported on the cash basis and then changed to the accrual method in 1957 to avoid the payment of taxes on the income from 1951 and 1952 sales. In his opening statement, respondent stated that the changes he himself had made in the earlier years were merely "adjustments" and limited solely to the years involved. Respondent asserted that "the adjustments were such that the respondent felt that the land contracts had value and therefore under a cash basis of accounting, they are properly includable in income" in the year of sale. Respondent stated that, in any event, there had been no requirement that petitioners change their method of accounting. Respondent next contends that the courts have followed the rule that, where deferred payments are evidenced only by a contract, as in this case, and no other evidence of indebtedness, such as a note or bond, is given to the vendor, the amount of the deferred payments should be included in income only when the payment is received. Harold W. Johnson, 14 T.C. 560 (1950). Therefore, respondent contends the gain should be reported in 1957 and 1958. Respondent's final contention is that, in any event, petitioners have failed to prove the land contracts in question had a fair market value in 1951 and 1952.

We have concluded that respondent's contentions must be rejected.

In essence, respondent has taken the position that the changes he made for the years 1953, 1954 and 1955 were merely corrections of errors, whereas, in the later years petitioners voluntarily changed their method of accounting by taking the same action. Then, respondent apparently proceeds to accept the new method for one purpose, i.e., to tax petitioners on the gain from the Murray sale in 1957, and reject it for another, i.e., to include the income from the 1951 and 1952 sales in 1957 and 1958. This position is untenable.

Assuming, arguendo, that petitioners' method of accounting was changed, sections 446 and 481 of the 1954 Code are relevant.

As originally enacted, section 481(a) provided that where taxable income for any year is computed under a method of accounting different from the method under which income was computed for the preceding year, there shall be taken into account those adjustments determined to be necessary solely by reason of the change in order to prevent amounts from being duplicated or omitted. However,

* The statement of facts is taken from the Tax Court syllabus. — ED.

an exception was made for any adjustment in respect of any taxable year to which section 481 did not apply; that is, a year not covered by the 1954 Code. Subsequently, the Technical Amendments Act of 1958 retroactively amended section 481(a) to provide that no adjustment in respect of pre-1954 Code years would be taken into account "unless the adjustment is attributable to a change in the method of accounting initiated by the taxpayer."

If the petitioners' method of accounting were changed, the crucial inquiry, under section 481(a), is whether the taxpayers "initiated" [1] the change. It is readily apparent that they did not. Prior to 1957, petitioners' method of accounting for sales, where a land contract was received, was to report the gain on a deferred basis. Respondent changed this method and compelled petitioners to report the gain from this type of sale in the year in which it was made. Respondent's action in this respect was no mere suggestion that petitioners make a change. Cf. Irving Falk, 37 T.C. 1078 (1962) (on appeal C.A. 5, July 30, 1962). Respondent took the first step to set the change in motion and took overt steps to cause it to be made; therefore, we conclude that petitioners did not initiate the change. United States v. Lindner, 307 F.2d 262 (C.A. 10, 1962); cf. Fred P. Pursell, 38 T.C. 263 (1962), affd. per curiam 315 F.2d 629 (C.A. 3, 1963). Thereafter petitioners merely began using the new method at the first available opportunity — 1957.[2] It would be unreasonable to expect them to have done otherwise. Having made his decision, respondent must abide by it with all its attendant consequences. Since respondent "initiated" the change and any adjustments would be with respect to pre-1954 Code years (1951 and 1952), no adjustments are required by section 481(a). Consequently, respondent's determination for 1957 and 1958 cannot as [be?] sustained under section 481.

Respondent has not cited or discussed the applicability of section 446, but he appears to rely on section 446(e) inferentially. If petitioners had changed their method of accounting without first requesting the permission of the respondent, it is possible he could have insisted that they revert to their old method. However, respondent can find no support in section 446(e) for his determinations since he was the one who caused the change to be made.

Finally, if we assume, arguendo, that respondent is correct, and that the changes he made for the years 1953, 1954 and 1955 were merely "adjustments" or a correction of errors and not a change in petitioners' method of accounting, petitioners must still prevail. Certainly, if the change made by respondent in 1953-1955 was merely an adjustment or correction, then the identical change made by petitioners in 1957 and 1958 can only be characterized in similar fashion. When, in 1957 and 1958, petitioners began reporting the entire gain from sales, where a land contract was received, in the year in which the sale was made, the change was entirely con-

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1 As used in section 481(a)(2), the word "initiate" has been interpreted to mean "to introduce by a first act; to make a beginning with; to originate; begin." Fred P. Pursell, 38 T.C. 263 (1962), affd. per curiam 315 F.2d 629 (C.A. 3, 1963); United States v. Lindner, 307 F.2d 262 (C.A. 10, 1962). Changes in methods of accounting initiated by the taxpayer include a change in method of accounting which he originates, by requesting permission of the Commissioner to change, and also cases where taxpayer shifts from one method of accounting to another without the Commissioner's permission. A change in the taxpayer's method of accounting required by a revenue agent upon examination of the taxpayer's return would not, however, be considered as initiated by the taxpayer. H. Rept. No. 775, 85th Cong., 1st Sess., p. 20 (1957), 1958-3 C.B. 830; S. Rept. No. 1983, 85th Cong., 2d Sess., p. 45 (1958), 1958-3 C.B. 966.

2 While it is true that petitioners stated in their returns that they were reporting on an "accrual basis," we are satisfied that they were only referring to the fact that they had changed their method of reporting gain from sales where a land contract was received. The use of the label "accrual basis" was, no doubt, due to the revenue agent's statement that petitioners were being placed on the accrual method of accounting. Respondent made no attempt, at the trial, to refute this view; although the examining agent was present at the trial, he did not testify.

sistent with the position respondent took for the prior years and the method was supported fully by the evidence of fair market value of the contracts in question.

The uncontradicted testimony of petitioners' expert witness, which we accept, was that the land contracts from the 1951 and 1952 sales had a fair market value equal to their face amount in the respective years in which they were received. Therefore, the income from the sales in 1951 and 1952 should have been reported in those years rather than in 1957 and 1958. John W. Commons, 20 T.C. 900 (1953); [§1001, §1002]. The fact that a taxpayer has not paid income tax on income in a previous period does not make it income in a subsequent period if it does not belong in that year. See Security Mills Co. v. Commissioner, 321 U.S. 281 (1944). . . .

We conclude that respondent's determinations for 1957 and 1958 were erroneous. Accordingly, we hold for the petitioners on this issue.

Reviewed by the Court.

NOTE

1. *The case law background of §481.* Before §481 was enacted in 1954, the Internal Revenue Service followed the practice of granting its consent to a change in accounting method (which was required by Regs. 118, §39.41-2(c)) only if the taxpayer agreed to appropriate transitional adjustments to prevent items from being taxed or deducted twice or from being omitted altogether. But a number of cases held that the Service's consent to a change of method was required only when the taxpayer wished to change from one *proper* method to another, and not on a change from an *improper* method to a proper one. Moreover, on such a change from an improper method, it was held that transitional adjustments were not necessary, at least not if the Service compelled the taxpayer to make the change. Commissioner v. Dwyer, 203 F.2d 522 (2d Cir. 1953), and cases there cited. In the case of a change from an improperly used cash method to an accrual method, consider the effect of failing to make adjustments in respect of (a) the collection in post-change years of accounts receivable that were not included in income in pre-change years, (b) the payment in post-change years of expenses incurred but not deducted in pre-change years, and (c) the existence at the beginning of the first accrual year of a merchandise inventory the cost of which was deducted in a prior cash basis year.

Section 481 was enacted in 1954 to require — whether the prior method of accounting was proper or not — the making of such transitional adjustments as are "necessary solely by reasons of the change in order to prevent amounts from being duplicated or omitted." Because the adjustments sometimes represent an accumulation of items that would have been taken into account over a long period of years had the old method not been changed or had the new method been used from the outset, §481(b) goes on to limit the tax burden in the year of the change to the amount of additional tax that would have been payable had the adjustments been taken into account in specified earlier years.

As the *Perelman* case indicates, §481 (as amended in 1958) requires adjustments to be made for pre-1954 years if they are attributable to a change of accounting method initiated by the taxpayer. As enacted in 1954, however, adjustments for pre-1954 years were not required regardless of who initiated the change, with the result that some taxpayers endeavored to change from the cash method to an accrual method in order to seize what appeared to be a once-in-a-lifetime opportunity of having their pre-1954 accounts receivable and inventories escape taxation. According to Prather v. Commissioner, 322 F.2d 931 (9th Cir. 1963), the Commissioner of Internal Revenue thereupon "started one of his most successful 'sit downs' in the history of American tax law" by refusing to approve applications for such changes until the adoption of the 1958 amendment to §481 discussed in the *Perelman* case.

2. *Adjustments to the pre-change years.* On the possibility of requiring the taxpayer in *Perelman* to pay additional taxes for 1951 and 1952, despite the running of the statute of limitations, see §1311, infra page 877. In Rev. Rul. 64-76, 1964-10 I.R.B. 15, the Internal Revenue Service announced that where action is taken under §481 to adjust post-1953 years, it would not attempt to apply §§1311-1315 "since the application of section

481 of the Code, by reason of the limitation provided for in section 481(a)(2) of the Code, is considered to preclude recourse to any such attempt."

3. *Consent to a change.* For the scope of the Commissioner's discretion under §446(e), requiring the taxpayer to obtain consent before changing his accounting method (or, more precisely, before computing taxable income under the new method), see Drazen v. Commissioner, 34 T.C. 1070 (1960) ("broad administrative discretion," not to be overturned unless the evidence clearly shows an abuse of discretion); St. Luke's Hospital, Inc. v. Commissioner, 35 T.C. 236 (1960) (re compliance with conditions).

4. *"Accounting method" vs. "adjustments."* The court in *Perelman* mentions, but does not discuss, the distinction between an "adjustment" or "correction of error" and a "change in accounting method." The Regulations provide that a change in accounting method includes "a change in the over-all method of accounting for gross income or deductions, or a change in the treatment of a material item," and gives several illustrations. Regs. §1.446-1(e)(2)(i) and (ii); see also Regs. §1.481-1(a)(1). See Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3d Cir. 1961) (accrual basis taxpayer changed manner of treating dividends on insurance policies; held, a change of accounting method); Dorr-Oliver, Inc. v. Commissioner, 40 T.C. 50 (1963) (accrual basis taxpayer had been deducting vacation pay when paid; held, a change to accrual of vacation pay is a change in method of accounting); Beacon Publishing Co. v. Commissioner, 218 F.2d 697 (10th Cir. 1955) (accrual basis taxpayer did not change accounting method when it began to allocate prepaid subscription income to years of subscription rather than to year of receipt); Fruehauf Trailer Co. v. Commissioner, 42 T.C. No. 6 (1964) (practice of inventorying trailers taken in trade at $1 each constitutes a "method of accounting").

Recognizing the difficulty of distinguishing between changes in accounting method and adjustments of errors, the Internal Revenue Service announced in Rev. Proc. 64-16, 1964-9 I.R.B. 35, that it was prepared to enter into agreements under which a change in "accounting practice for tax purposes with respect to particular items of income or expense to an acceptable treatment of such items" would be approved, with transitional adjustments allocated over a 10-year period to eliminate distortions of tax and income. Section 481 is sidestepped by this procedure, since the agreement is to provide that neither the taxpayer not the Service will raise or concede the question of whether such a change is a change of "accounting method" within the meaning of §446 or §481.

5. *References.* Barnes, Changes in Accounting Methods, 1962 Tulane Tax Inst. 470; Dakin, The Change from Cash to Accrual Accounting for Federal Income Tax Purposes — Pyramided Income, Double Deductions and Double Talk, 35 Taxes 782 (1957), also in 51 Nw. U.L. Rev. 515 (1956); Note, Problems Arising from Changes in Tax-Accounting Methods, 73 Harv. L. Rev. 1564 (1960).

Section B. Some Problems of Fluctuating Income

1. *Averaging*

Sections 1301-1305, moderating the tax rate on "averageable income," were enacted in 1964 in substitution for provisions (carried forward from the 1939 Code) that permitted a few categories of income to be "spread-back" for tax purposes.

Before 1964, the principal statutory provisions (aside from the special treatment of capital gains) for moderating the impact of the progressive rate structure on "bunched" income were §§1301-1305 of the 1954 Code, which provided in general that the tax on qualified income in the year of receipt could not exceed the tax that would have been payable if the income had been received in equal installments over a specified earlier period. Only a few categories of income qualified for this "spread-back" method of computing the tax: income from "an employment" (defined as an arrangement for the performance of personal services "to

effect a particular result") covering a period of 36 months or more; income from "an invention or artistic work" created by the taxpayer over a period of 24 months or more; "back pay" awards; and damages for patent infringement, breach of contract, and breach of fiduciary obligation. In the case of income from "an employment," the income in the taxable year had to constitute 80 per cent or more of the total compensation to be received for the services, and in the case of income from an invention or artistic work, the current year's receipts qualified for relief only if they constituted 80 per cent or more of the aggregate amount so far received in respect of the invention or artistic work; a "back pay" award, on the other hand, qualified only if it exceeded 15 per cent of the taxpayer's gross income in the year of receipt. In general, the relief granted by the pre-1964 provisions depended on the tax that would have been payable if the qualified amounts had been received over some earlier period, the length of which varied with the category of income received. In determining these hypothetical increases in taxes, it was necessary to recompute the medical expense and charitable deductions and the alternative tax on capital gains, to take account of loss carryovers, and to make some other adjustments that would follow automatically from a change in the earlier year's receipts. For some of the problems and limitations of the pre-1964 statutory provisions, see Harris, Spreading Fees Forward and Back, 18 N.Y.U. Inst. on Fed. Taxation 1231 (1960); for alternative proposals, see the articles by various authors, 1 Tax Revision Compendium (House Committee on Ways and Means, 1959) 579-677.

Responding to a recommendation in President Kennedy's 1963 Tax Message for the enactment of "one formula of general application to those with wide fluctuations in income" to replace "the narrowly confined and complex averaging provisions of present law," Congress in 1964 repealed §§1301-1305 of the 1964 Code* and replaced them with new provisions (also numbered §§1301-1305) of much wider applicability. The new provisions were described as follows by the Senate Finance Committee:

(*b*) *General reasons for provisions.* — A general averaging provision is needed to accord those whose incomes fluctuate widely from year to year the same treatment accorded those with relatively stable incomes. Because the individual income tax rates are progressive, over a period of years those whose incomes vary widely from year to year pay substantially more in income taxes than others with a comparable amount of total income but spread evenly over the years involved. This occurs because the progressive rates take a much larger proportion of the income in taxes from those whose incomes in some years are relatively high. The absence of any general averaging device has worked particular hardships on professions or types of work where incomes tend to fluctuate. This is true, for example, in the case of authors, professional artists, actors, and athletes as well as farmers, fishermen, attorneys, architects, and others.

The present averaging provisions have proved unsatisfactory, first because they are limited to a relatively small proportion of the situations where averaging is needed. Thus, while they presumably cover inventors and writers, they do not provide for actors, athletes, and in most cases do not provide for attorneys, architects, and others. Even in the case of inventors and authors, the present provision is inadequate because of the requirement that the income arise over at least a 24-month period and 80 percent or more of the income from the invention or work be concentrated in the current year in question. In practice, many cases involving authors and inventors where averaging is needed do not meet these specific requirements. This was made clear in testimony from authors and others.

* Old §1301 (income from "an employment") remains in effect for projects begun before Feb. 6, 1963; but a taxpayer who wishes to be governed by this provision must forego any benefits under new §§1301-1305. Another pre-1964 spread-back provision (§1306, relating to damages for antitrust violations) was retained intact.

The present averaging provisions also have proved unduly complicated in practice because of the requirement that the prior years' incomes and taxes must be recomputed as if the income had actually been received in those prior years. . . .

(c) *General explanation of provisions.* — In view of the considerations set forth above, the bill deletes all of the averaging provisions in present law referred to previously and substitutes instead an income averaging device available to individual taxpayers generally, substantially without regard to the source of the income. As indicated subsequently, however, in the case of the averaging device for compensation from an employment, the bill in certain cases permits the continuance of the application of this provision.

Under the averaging rule provided by the bill, once the amount of income to be averaged is determined — called averageable income in the bill — and assuming this amount is more than $3,000, the taxpayer is to compute a tentative tax on one-fifth of this amount. The tax on this one-fifth is determined by adding this one-fifth to 1⅓ times the average income received in the prior 4 years, plus the average capital gains income in this same 4-year period. The tax attributable to this one-fifth is then multiplied by 5 to determine the final tax on this income.

Averaging is available only where the "averageable income" exceeds $3,000 because, with the present progressive rate structure with tax brackets usually of $2,000 to $4,000, smaller amounts achieve little if any benefit from averaging. The device of including one-fifth of the averageable income in the tentative tax base, computing the tax attributable to this amount, and then multiplying this result by 5, achieves a result which is substantially similar (except when there are rate changes during the 5 years) to including one-fifth of the income eligible for averaging in the taxable income base of each of the prior 4 years and of the current year. The advantage of making the computation in this manner is that it is not necessary to recompute the tax for each of the 4 prior years in order to obtain this result.

The "averageable income" referred to here is the excess of the taxable income in the current or computation year — with certain adjustments — over 1⅓ times the average base period income. The average base period income is the average of the taxable income in the 4 prior years with certain adjustments specified below.

Averageable income is limited to that which is in excess of 1⅓ times average income in the base period for two basic reasons. First, in any new provision of this type, it is necessary to limit the number of cases to which the new provision will apply to a manageable level from the administrative standpoint. In other words, it was necessary initially, at least, to limit the volume of cases where averaging will be applied. Moreover, it is clear that the greatest need for averaging occurs where the fluctuation in income levels varies widely. An increase of more than one-third from the prior average income was selected to make the new averaging rule available in those cases where it is needed the most.

As indicated above, in computing the income subject to averaging, it is necessary to make some adjustments in both the income of the current, or computation year, and also in the income of the 4 base period years with which the current year's income is compared. The income of the computation year, referred to in the bill as the "adjusted taxable income" is the taxable income for that year decreased by: (1) Any capital gain net income for that year; (2) any income for that year attributable to gifts, bequests, devises, or inheritances received during that year or any of the four prior base period years;[1] (3) any excess of wagering gains in the year over wagering losses; and (4) certain amounts of income to which penalties apply with respect to owner-employees who are self-insured for pension plan purposes (sec. 72(m)(5)).

Long-term capital gains are excluded from the income subject to averaging in the computation year on the grounds that such income does not require averaging because of the fact that only 50 percent of the capital gain income is included in the tax base in any event. Moreover, without regard to the averaging provision, such income is subject to a maximum rate of 25 percent.

Averageable income also excludes income from gifts, devises, or inheritances where the

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[1] Income attributable to gifts, bequests, devises, or inheritances between a husband and wife are not taken out of the income for the computation year if they file a joint return for the computation year or one of them makes a return in that year as a surviving spouse. Also not taken into account are amounts of less than $3,000 in computation year.

gifts, etc., have been received either in the computation year or in any of the four prior base period years, because such income does not arise from any additional efforts on the part of the taxpayer but merely represents a transfer to the taxpayer of income previously received by someone else. In addition, in the case of the transfer by gift of income producing properties between related parties, there would be some opportunity for manipulation if such income were not excluded from that which can be averaged. Income attributable to such property is excluded under the bill only where it is in excess of $3,000 in the computation year. Also, because it may be difficult to trace specific income to specific gifts, bequests, devises, or inheritances, the bill presumes that such property earns a 6-percent rate of return unless the taxpayer establishes to the satisfaction of the Treasury that some other amount of income is earned with respect to the property.

Net wagering gains are excluded from averageable income to prevent such income from receiving a preferred status. For similar reasons, penalty income of owner-employees in the case of self-insured pension plans is excluded.

It is also necessary to make some adjustments in the base period income with which the adjusted taxable income for the computation year is compared. Two of these adjustments are the same as those made in the computation year. Thus, capital gain net income for the base period year is excluded as is any income from gifts, bequests, devises, or inheritances where such property was initially received by the taxpayer in 1 of the 4 base period years.

A third adjustment made to the average base period income is to add back to such income any income excluded from the taxpayer's base in such year on the grounds that it was earned in a foreign country (the exclusion under sec. 911 of present law) or on the grounds that it was income from sources within a possession of the United States (sec. 931 of present law). The inclusion of such amounts in the base period is necessary so that the taxpayer will not become eligible for averaging merely on the grounds that during the 4-year base period, or a part of this period, he was in a foreign country and not subject to U.S. tax on his earned income. If such amounts are not included in the base period income comparable amounts earned in the United States in the computation year would be eligible for averaging.

(c)(i) *Example.* — For most taxpayers with little or none of the income which gives rise to the special exceptions described above the application of this averaging provision is relatively simple. This can be illustrated by an example of an unmarried taxpayer having an average base period income of $3,000 in the years 1961-64 and an adjusted taxable income of $44,000 in 1965. The taxpayer in this case is eligible for averaging since his "averageable income" exceeds $3,000. His averageable income in this case can be computed as follows:

1. Adjusted taxable income in computation year	$44,000
2. 133⅓ percent of average base period income ($3,000 × 133⅓ percent)	4,000
3. Averageable income	40,000

Since the averageable income is in excess of $3,000, the entire amount is subject to averaging.

Computation of tax:

(a) 133⅓ percent of average base income ($3,000 × 133⅓ percent)	$4,000
(b) Averageable income included in tentative tax base (⅕ of $40,000)	8,000
(c) Tentative taxable income	12,000
(d) Total tentative tax liability (1965 rates under bill)	2,830
(e) Tax on $4,000 not subject to averaging	690
(f) Tax liability on ⅕ of averageable income	2,140
(g) Tax on total averageable income ($2,140 × 5)	10,700
(h) Total final tax liability (tax on $4,000 not subject to averaging and $40,000 subject to averaging)	11,390
(i) Tax on $44,000 under 1965 rates without averaging	18,990

[S.Rept. No. 830, 88th Cong., 2d sess., pp. 139-143.]

In order to prevent a person who has just joined the labor force upon leaving school or college from averaging his earned income by reference to base period

years in which he was supported by his parents or others, §1303(c)(1) lays down the general rule that a taxpayer is not eligible to average his income if he (and his spouse, if he is married) furnished less than one-half of his support during any base period year. This general rule is then modified by three exceptions: (1) To avoid disqualifying a taxpayer who was in the labor force but was unemployed during part or all of the base period, §1303(c)(2)(A) excepts a person who is over 25 in the computation year if there have been at least four years since he was 21 when he was not a full-time student; (2) to protect a taxpayer who receives payment in the computation year for work performed during the base period, §1303(c)(2)(B) exempts from the general rule a taxpayer if more than one-half of his adjusted taxable income in the computation year is attributable to work performed in substantial part during two or more of the base period years; and (3) to protect a taxpayer whose spouse was not self-supporting during the base period, §1303(c) (2)(C) permits averaging the income on a joint return if not more than 25 per cent of the aggregate adjusted gross income is attributable to the spouse who was not self-supporting during the base period.

The new provisions contain a number of other qualifications, restrictions, and operating rules, governing such matters as the eligibility of persons who file a joint return in the computation year but separate returns in one or more of the base period years (or vice versa), the order in which averageable income and non-averageable income are to be taken into account in computing the tax in the computation year, etc.

2. *Loss Carryovers*

Section 172 of the 1954 Code, relating to operating loss carryovers, is based on §122 of the 1939 Code, with substantial modifications.

Section 1212 of the 1954 Code, relating to the carryover of capital losses, was derived from §117(e) of the 1939 Code, but was amended in 1964.

TREASURY DEPARTMENT AND JOINT COMMITTEE ON INTERNAL REVENUE TAXATION, BUSINESS LOSS OFFSETS *2-11 (1947)*

III. Purposes of Business-Loss Offsets

A. *Equity Considerations*

In the absence of the loss offsets, the business entity whose net income becomes negative in some periods is not permitted to deduct all the expenses of earning income. To this extent, the tax on net income becomes a tax on capital. The owners of such a firm are discriminated against, because higher taxes are levied on their net income than on the income of owners of businesses with stable income.

B. *Economic Considerations*

1. *To remove impediments to risk-taking*

Without loss offsets, investments in assets with less risk of loss are favored over those in which the risk may be greater. Thus, the absence of loss offsets will reduce the relative investment in risky assets and ventures. Investment in such assets and ventures may be particularly desirable in the economy. Ventures may be risky because they are new firms challenging established ones or introducing new products. If successful, they bring reduced prices in the industry they enter, or may

create employment in an entirely new industry. They may be faced with a period of hard sledding and losses in their early years. If losses in this period cannot be offset against income of future periods, the prospective return from the investment is reduced relative to the return connected with a safer haven for their funds.

2. *To increase the countercyclical effect of taxes*

Absence of loss offsets may also contribute to cyclical instability. In years of losses, expenditures will be held to a minimum. The making of these expenditures may be unprofitable when the firm bears their full cost but must pay a tax on the additional income they would bring in. Yet, they might profitably be made if the cost of the expenditure could reduce taxes through loss offsets. . . .

IV. The Offset of Business Losses

The desirability of increased loss offsets is evident from consideration of equity and economic effects, with administrative considerations a negative item. These major questions still remain: (1) In what direction should losses be offset? (2) For how long a period should they be offset? and (3) How should they be determined?

A. *The Direction In Which Losses Should Be Carried*

The carryforward permits losses of one year to be carried forward as a deduction from net income of future years. The carryback permits losses of one year to be carried back as a deduction from net income of past years. The choice, based upon the purpose of loss offsets, must be made between these two devices.

1. *Equity considerations*

The equity problem in the case of corporate income is to define and tax net income as correctly as possible over time so that stockholders in different companies will receive equal treatment. The equity goal clearly is not permitting all losses to be deducted from all income over a *corporation's* life. Since stockholders change, it would mean that some costs incurred and losses sustained by one group of stockholders would be deducted from income received by another group of stockholders. Under no definition of income would this be correct.

It should be recognized, moreover, that most "losses" are forward looking. Most dollars spent by a business enterprise are for the purpose of bringing in future, not past, income, and should, therefore, be deducted from future, not past, income. If all revenue and all expenses were allocated with perfect foresight, losses would arise only when the firm was making "capital" outlays to increase future income. Most "losses" would then be carried forward. A similar conclusion would hold if all expenditures were deducted when made. Carrying losses forward would result in a more correct statement of income than carrying them backward. Income would not be taxed until all capital was recovered.

Under the present concept of taxable income there are three major exceptions to this simple rule. Costs obviously of a capital nature must be spread over the "useful" life of the asset. Changes in the useful life of the asset can then give rise to obsolescence losses which are properly deducted from past, not future, income. A further qualification arises in connection with inventories. Purchases of goods are expensed only to the extent they are not on hand at the end of the year. Most methods of valuing inventories result in an overstatement of income when prices rise and an understatement when prices fall. Resulting inventory losses are directly related to the inventory previously arising. Bad debts, arising from sales of an earlier period, are related to the sales of that earlier period.

It should be noted that, since devices are available to correct most of these aberrations from the simple doctrine, these costs are insufficient grounds for es-

pousal of carrybacks. Increased depreciation, a different method of spreading capital costs, or the carryback of the unrecovered cost of depreciable assets, could adjust for obsolescence. Inventory reserves or last-in-first-out inventory valuations would substantially remove the possibility of inventory losses associated with past income. Accrual of potential bad-debt losses adjusts for this lagged expense.

It would appear, therefore, that the carryforward would be more equitable than the carryback, since it would generally result in a better determination of income. . . .

2. *Economic considerations*

a. *Stimulating new business enterprises.* The carryforward is obviously superior to the carryback in stimulating the entry of new business enterprises. Any initial losses the new enterprise sustains in order to enter an industry are really capital costs of earning future income. Only by means of a carryforward can they be offset against that income.

Moreover, so long as a carryback is permitted, even if a carryforward can also be made, the new enterprise would be at a disadvantage. If the entry of such an enterprise were followed by sharp competitive warfare which results in losses in the industry, the established company would be able to recoup a portion of its losses from the Government by way of the carryback, but the new enterprise could not. The latter would have to wait for future profits to recover a portion of its losses. Yet the prospect of future profits is made more uncertain because the Government would partially underwrite its competitors.

For the purpose of stimulating the entry of new business units, the carryforward seems clearly preferable to the carryback.

b. *Relative countercyclical effects.* Both carryforwards and carrybacks would have some countercyclical effect. Both would stimulate business expenditures somewhat in periods of losses (depressions) because the opportunity of offsetting such expenditures against taxable income would reduce the cost of the outlays.

The effect of a carryback would be more certain than that of a carryforward. The firm would be sure at the time of making the outlay that the carryback would reduce taxes already paid in prior years. A carryforward would reduce taxes only if profits were realized in future years. Because of the greater certainty of the tax effect, carrybacks might stimulate business expenditures during a period of losses somewhat more than carryforwards. Presumably, however, business expenditures are nearly always made with the expectation that they will result in later profits, and the difference as to certainty of tax benefit is probably not very significant. . . .

It appears that carrybacks may stimulate business expenditures during a depression to a slightly greater extent than carryforwards. It seems unlikely, however, that the difference between carrybacks and carryforwards in this respect will be very great, or that either carrybacks or carryforwards will have an important countercyclical effect.

3. *Administrative considerations*

The carryback is generally more difficult to handle administratively than the carryforward. Under the former, the returns of past years must be kept open. Even if they were closed, to be reopened only for purposes of a carryback, a problem would be presented. Compromises are a give-and-take proposition in which a result satisfactory to the Government and the taxpayer is reached. The final result might differ if at the time of making the compromise it were known that a carryback would arise. In many cases, therefore, compromises would be postponed, or an agreement reached which would not have been reached if future events were then known.

The carryforward, on the other hand, requires audit of losses which were pre-

viously passed over. If the carryforward period is long, either the statute of limitations must be extended or the rule adopted that a net operating loss deduction represents an election by the Government [taxpayer?] to waive the statute for the years in question. The audit of losses sustained a considerable period in the past is, of course, difficult.

B. *The Length of Time Over Which a Loss May Offset Income*

In terms of the purposes of loss offsets, there appears to be no theoretical limit to the length of time losses should be carried forward. However, business plans are made, generally, for a relatively short period. The desirable stimulus of loss offsets can be achieved by a period considerably shorter than, say, 10 years. Furthermore, the absence of a theoretical limit to the length of carryforward can be qualified. Future income cannot be clearly foreseen, and unduly long carryforwards might in some cases result in tax reductions that would do no good from the point of view of incentives. This would be the case where the profits of a depressed industry suddenly increased and went untaxed because of the carryforward of losses of years long past. An example of such a situation is the wartime increase in the earnings of railroads after the difficult period of the 1930's.[1] There are serious administrative objections, moreover, to lengthy carryforwards as has been indicated earlier. Some compromise must be made, along the lines of choosing a period which will offset the bulk of losses and yet be administratively feasible.

There are no data conclusively indicating the effectiveness of different periods for offsetting losses. . . .

Since the average business cycle does not appear to exceed about 8 years in length,[2] a five year period would be long enough to allow all losses attributable to general depressions to be applied against income of generally prosperous years. However, a 5-year period might not be long enough to meet the requirements of new firms and of firms whose profits fluctuate over a cycle longer than the general business cycle. . . .

C. *The Kind of Loss To Be Carried Over*

There are two sharply conflicting theories on the question of the kinds of losses and the kinds of income which should be used in calculating the loss offset. One approach is to determine them in the same way as taxable income is determined. This process excludes from the calculation such items as tax-exempt interest and 85 percent of intercorporate dividends which were not used in calculating taxable income or net loss for the purposes of the original tax. It is argued that because they were omitted in that connection they ought not to be used in calculating the loss which is to be carried over, or net income against which the loss is to be offset.

The opposing view starts with the presumption that a loss offset should not come into operation until a "true" loss has been sustained, i.e., until total net income is negative. According to this view, an operating loss is not a "true" loss if in the year in which it is incurred there is, for instance, income from tax-exempt

1 The net operating loss deductions of transportation and public utility corporations in 1940-42 alone were $236 million as compared with $231 million for the entire period 1922-1932. For no other industry group was there an absolute increase in the size of net operating loss deductions between these two periods. With a longer carryforward, the increase in operating loss deductions of transporation and public utility corporations would have been greater.

2 Alvin H. Hansen, Fiscal Policy and Business Cycles (1941), pp. 18-19. Other students focus attention on a cycle of only 40 to 50 months' duration. See, for example, Arthur F. Burns and Wesley C. Mitchell, Measuring Business Cycles (National Bureau of Economic Research, 1946), pp. 78, 401, 412.

securities which can absorb the "loss" in whole or in part. It is only the excess of deductions over total income, including income which is ordinarily excluded from the calculation of taxable income, that should be counted as a loss for the purpose of offsetting income of another period. As a corollary, it follows that in the year in which this "true" loss is applied, it should be counted against total net income accrued, not merely taxable income. In practice, this means that the taxpayer will have to show a deficit in taxable income in excess of the income which is ordinarily excluded from the calculation of taxable income before any benefit will be received.

While the present law is not a perfect application of either theory, it is drawn primarily in terms of the "true" loss idea.*

The existing law falls short of the total-income theory in that total income is understated by the omission of such exempt items as recoveries of certain bad debts, taxes, etc., certain forgiveness of indebtedness, receipts from life insurance policies, military pay and allowances, the surtax exemption for certain preferred-dividend payments of public utilities, and other similar exemptions. The total income used is overstated by the non-deduction of capital losses in excess of gains, and business expenses deemed extraordinary or unnecessary or otherwise not deductible.

Advocates of the taxable-income approach place primary emphasis upon the inconsistency of granting a concession to such items as interest from exempt securities, long-term capital gains, intercorporate dividends, and percentage depletion, in calculating annual taxable income, and not permitting the same concession in determining income over a longer period of time when such income fluctuates. As they point out, this leads to inequities as between taxpayers with fluctuating and stable incomes. Thus, where two mining companies, perhaps direct competitors, have equivalent production and income over a period of time, one will be denied percentage depletion whereas the other will obtain it. Similarly, where two corporations each receive the same amount of dividends from domestic corporations, one must include 100 percent of such dividends as taxable income, while the other need include only 15 percent. Advocates of the taxable-income approach believe that such discrimination cannot be reconciled with the previously stated purpose of the loss carryover which is to define and tax net income as correctly as possible over time so that different taxpayers will receive equal treatment.

Advocates of the total-income approach point out that the basic purpose of the loss offset — to prevent the taxation of capital as income — is satisfied by this method; that the cancellation of the tax exemption under the total-income theory does not result in the taxation of income at rates higher than the statutory one. Moreover, they hold that whether or not undesirable discrimination results from the total-income approach depends on the standard of comparison. If the taxpayer with tax-exempt income whose income fluctuates is compared with a taxpayer with no tax-exempt income, the law would still favor the former. . . .

NOTE

1. *Changes in the net operating loss deduction.* A number of changes in the operating loss deduction were made by the 1954 Code. In calculating the amount of the deduction, the "taxable income" approach discussed in the foregoing extract is accepted to a much greater degree than formerly, and adjustments are no longer required for tax-exempt interest, the excess of percentage over cost depletion, or the untaxed portion of dividends received. Another important change relates to §172(d)(4). The corresponding provision

* This is less true today, as a result of changes in 1954. — Ed.

of the 1939 Code, §122(d)(5), was construed to prevent the carryover of a loss incurred on the sale of property used in the taxpayer's trade or business (e.g., a farm or factory) unless he was in the business of selling such property. Sic v. Commissioner, 177 F.2d 469 (8th Cir. 1949), cert. denied, 339 U.S. 913 (1950); but see Goble v. Commissioner, 23 T.C. 593 (1954). As amended, §172(d)(4) permits the carryover of such a loss. It also permits the carryover of a casualty loss (e.g., from fire, drought, etc.).

The five-year carryforward period of pre-1954 law was not changed, but the carryback period was lengthened to two years by the 1954 Code and to three years by a 1958 amendment.

On the extent to which errors in computing taxable income in a prior year may be corrected (even after the statute of limitations has run) in determining the amount of the carryback to that of other years, see Springfield Street Railway Co. v. United States, 312 F.2d 754 (Ct. Cl. 1963).

For the use of an operating loss carryover by a successor corporation, and the related problem of acquisitions of "loss" corporations, see page 428 supra.

2. *Tentative refunds to taxpayers with operating losses.* In order to increase the usefulness of the §172 carryback, a taxpayer may file an application under §6411 for a tentative refund of the previous year's taxes. The application must in general be acted upon within ninety days, but errors disclosed by subsequent audit can be corrected. Moreover, under §6164 a corporation expecting a §172 carryback from its operations in the current year may obtain an extension of time for the payment of taxes for the previous year.

3. *Carryover of capital losses and other items.* A net capital loss may be carried forward by virtue of §1212; the carryover period is five years for corporations, but it is unlimited (as a result of a 1964 amendment) for other taxpayers. In a few instances, the effect of a ceiling on a specific deduction is mitigated by a provision for carrying forward the amount that is not currently deductible (e.g., §170(b)(2), relating to excess charitable contributions made by a corporation; §404(a)(1)(D), relating to excess payments to a qualified pension trust).

There are some items that can never be carried over. Among them are personal expenses (e.g., taxes and interest) and personal and dependency exemptions.

4. *References.* Sanden, Techniques and Computations of the Net Operating Loss Deduction, 21 N.Y.U. Inst. on Fed. Taxation 1227 (1963); Lanahan, Net Operating Loss Deduction, 1960 Tulane Tax Inst. 87; Graichen, The Net Operating Loss, 16 N.Y.U. Inst. on Fed. Taxation 865 (1958); and, for the economics of the deduction, Beck, Carryover of Business Losses, 6 Nat. Tax J. 69 (1953).

SECTION C. THE TAXABLE YEAR AS THE ACCOUNTING PERIOD

1. *Items in Dispute*

NORTH AMERICAN OIL CONSOLIDATED v. BURNET

286 U.S. 417 (1932)

MR. JUSTICE BRANDEIS delivered the opinion of the Court.

The question for decision is whether the sum of $171,979.22 received by the North American Oil Consolidated in 1917, was taxable to it as income of that year.

The money was paid to the company under the following circumstances. Among many properties operated by it in 1916 was a section of oil land, the legal title to which stood in the name of the United States. Prior to that year, the Government, also claiming the beneficial ownership, had instituted a suit to oust the company from possession; and on February 2, 1916, it secured the appointment of a receiver to operate the property, or supervise its operations, and to hold the net income thereof. The money paid to the company in 1917 represented the net profits which had been earned from that property in 1916 during the receivership.

The money was paid to the receiver as earned. After entry by the District Court in 1917 of the final decree dismissing the bill, the money was paid, in that year, by the receiver to the company. United States v. North American Oil Consolidated, 242 Fed. 723. The Government took an appeal (without supersedeas) to the Circuit Court of Appeals. In 1920, that Court affirmed the decree. 264 Fed. 336. In 1922, a further appeal to this Court was dismissed by stipulation. 258 U.S. 633.

The income earned from the property in 1916 had been entered on the books of the company as its income. It had not been included in its original return of income for 1916; but it was included in an amended return for that year which was filed in 1918. Upon auditing the company's income and profits tax returns for 1917, the Commissioner of Internal Revenue determined a deficiency based on other items. The company appealed to the Board of Tax Appeals. There, in 1927, the Commissioner prayed that the deficiency already claimed should be increased so as to include a tax on the amount paid by the receiver to the company in 1917. The Board held that the profits were taxable to the receiver as income of 1916; and hence made no finding whether the company's accounts were kept on the cash receipts and disbursements basis or on the accrual basis. 12 B.T.A. 68. The Circuit Court of Appeals held that the profits were taxable to the company as income of 1917, regardless of whether the company's returns were made on the cash or on the accrual basis. 50 F.(2d) 752. This Court granted a writ of certiorari. 284 U.S. 614.

It is conceded that the net profits earned by the property during the receivership constituted income. The company contends that they should have been reported by the receiver for taxation in 1916; that if not returnable by him, they should have been returned by the company for 1916, because they constitute income of the company accrued in that year; and that if not taxable as income of the company for 1916, they were taxable to it as income for 1922, since the litigation was not finally terminated in its favor until 1922.

First. The income earned in 1916 and impounded by the receiver in that year was not taxable to him, because he was the receiver of only a part of the properties operated by the company. Under Sec. 13(c) of the Revenue Act of 1916, receivers who "are operating the property or business of corporations" were obliged to make returns "of net income as and for such corporations," and "any income tax due" was to be "assessed and collected in the same manner as if assessed directly against the organization of whose business or properties they have custody and control." * The phraseology of this section was adopted without change in the Revenue Act of 1918, 40 Stat. 1057, 1081, c. 18, Sec. 239. The regulations of the Treasury Department have consistently construed these statutes as applying only to receivers in charge of the entire property or business of a corporation; and in all other cases have required the corporations themselves to report their income. Treas. Regs. 33, arts. 26, 209; Treas. Regs. 45, arts. 424, 622. That construction is clearly correct. The language of the section contemplates a substitution of the receiver for the corporation; and there can be such substitution only when the receiver is in complete control of the properties and business of the corporation. Moreover, there is no provision for the consolidation of the return of a receiver of part of a corporation's property or business with the return of the corporation itself. It may not be assumed that Congress intended to require the filing of two separate returns for the same year, each covering only a part of the corporate income, without making provision for consolidation so that the tax could be based upon the income as a whole.

* The current equivalent of this provision is §6012(b)(3). — Ed.

Second. The net profits were not taxable to the company as income of 1916. For the company was not required in 1916 to report as income an amount which it might never receive. See Burnet v. Logan, 283 U.S. 404, 413. Compare Lucas v. American Code Co., 280 U.S. 445, 452; Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363. There was no constructive receipt of the profits by the company in that year, because at no time during the year was there a right in the company to demand that the receiver pay over the money. Throughout 1916 it was uncertain who would be declared entitled to the profits. It was not until 1917, when the District Court entered a final decree vacating the receivership and dismissing the bill, that the company became entitled to receive the money. Nor is it material, for the purposes of this case, whether the company's return was filed on the cash receipts and disbursements basis, or on the accrual basis. In neither event was it taxable in 1916 on account of income which it had not yet received and which it might never receive.

Third. The net profits earned by the property in 1916 were not income of the year 1922 — the year in which the litigation with the Government was finally terminated. They became income of the company in 1917, when it first became entitled to them and when it actually received them. If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. See Board v. Commissioner, 51 F.(2d) 73, 75, 76. Compare United States v. S. S. White Dental Mfg. Co., 274 U.S. 398, 403. If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year. Compare Lucas v. American Code Co., supra.

Affirmed.

NOTE

1. *Basis of Court's holding in North American Oil Consolidated v. Burnet.* Was it the dispute or the receivership that prevented the income from being taxable in 1916? If the former, why was the income taxable in 1917, when the dispute was still alive? If the latter, why shouldn't an accrual basis taxpayer be taxed on the basis of its *rights,* rather than its receipts? (There was no finding as to whether the taxpayer was on the cash or the accrual basis, but if this was relevant, the case could have gone back for a determination of this question.) Would the result have been different if in 1916 the court had denied the application for a receiver but had required the taxpayer to post a bond to secure payment of any judgment that might be entered? Could the taxpayer have protected itself from liability in 1917 by treating the receipt as a trust fund pending outcome of the appeal, e.g., by depositing it in a special account and labeling it as a trust fund on its books? Commissioner v. Alamitos Land Co., 112 F.2d 648 (9th Cir. 1940), cert. denied, 311 U.S. 679; Rev. Rul. 55-137, 1955-1 C.B. 215.

The receipt of the funds in 1917 means that both the taxpayer and the government will be alert to the possibility that they should be reported then. (If the $172,000 was not reported by the taxpayer, the government would be put on notice of its receipt by Schedule M of the corporate return.) If the Court had held that the funds were not taxable until 1922, would there be any formal way in which the government would become aware of the item if it was not reported by the taxpayer? Should disputed items, in other words, be reported not later than the year of receipt lest they be overlooked altogether?

2. *Can a "claim of right" be disclaimed?* The taxpayer, a motor carrier, contracted to transport government property at not more than the lowest rate charged by land-grant railroads between the same points. The taxpayer was advised by the government that because the land-grant rates were not available, it should charge at its regular tariff rates

and that the General Accounting Office, on a subsequent audit, would ascertain the correct charge and make demand for the overcharges. This practice was followed. On estimating that the land-grant rates were about 17 per cent below its regular rates, the taxpayer offered to renegotiate the contract on this basis, but the offer was rejected by the government. In computing its taxable income, the taxpayer deducted from gross operating revenues from the transportation of government property an amount of 17 per cent as a reserve for the refunding of overcharges. The amount actually refunded in later years was substantially less. It was held that the only amount that could be excluded from income in the year the transportation occurred, under the *North American Oil* case, was the amount actually repaid in the later years. Bates Motor Transport Lines, Inc. v. Commissioner, 200 F.2d 20 (7th Cir. 1952). Was the taxpayer taxed on more than it received under "a claim of right"?

The taxpayer in Fender Sales, Inc. v. Commissioner, ¶63,119 P-H Memo T.C., received a bonus from his employer (a wholly owned corporation) but returned it in the same calendar year because of the corporation's precarious financial condition. The court held that the bonus was not taxable to him: "where prior to the close of the taxable year there has been an adjustment of the contract or obligation and a repayment of a portion of the amount received, the tax liability is to be determined on the basis of the adjusted amount."

3. *Adjustment in year of repayment.* Note the statement at the end of the opinion about a deduction in the year of refund if the amount had been repaid by the taxpayer; see also United States v. Lewis, supra page 103. Section 1341 provides, in effect, that if the deduction exceeds $3000, the tax benefit to be derived therefrom shall not be less than the amount of tax attributable to the inclusion of the item in the earlier year. Would §1341 be applicable to the *Shannonhouse* case, supra page 535.

Why is an exception made in §1341(b)(2) for income from the sale of inventory items and stock in trade?

Section 1342 is the converse of §1341, permitting the taxpayer who took a deduction for an amount paid and must report a refund as income in the year of receipt to limit the tax in the latter year to the amount of tax saved in the year of the deduction. Unlike §1341, however, §1342 is available only in a highly special situation: a refund of an amount paid as a result of a patent infringement action where the decision was induced by fraud and later reversed.

4. *Reference.* Comment, Taxing Unsettled Income: The "Claim of Right" Test, 58 Yale L.J. 955 (1949).

COMMISSIONER v. BROOKLYN UNION GAS CO.

62 F.2d 505 (2d Cir. 1933)

Before MANTON, L. HAND, and SWAN, Circuit Judges.

SWAN, Circuit Judge.

The income tax in dispute is that of the Brooklyn Union Gas Company and its five subsidiary corporations for the taxable year 1922. The respondent and its subsidiaries were engaged in the manufacture, distribution, and sale of illuminating gas in Brooklyn and its environs. Beginning with the year 1916, some or all of these companies were continuously involved in rate litigation until the controversies were settled in their favor in 1922. Out of this litigation has arisen a dispute as to the amount of their taxable income for that year. Voluminous findings of fact are set out in the opinion of the Board in 22 B.T.A. 507, and we shall restate them only to the extent deemed necessary for an understanding of the issues here presented.

In the so-called Rate Cases No. 1 the New York Public Service Commission issued orders in May, 1916, directing four of the subsidiary companies to reduce their rates. Proceedings were immediately instituted in the state court attacking the reduced rates as confiscatory, and an interlocutory order was made staying execution of the commission's reduced rates and directing that moneys collected in excess thereof be impounded in a bank subject to further order of the court.

In July, 1919, the excess moneys so impounded were withdrawn by the companies, pursuant to court order, upon the giving of a bond for repayment in the event that the reduced rates should finally be sustained. In August, 1922, the commission abrogated, as of their original date, its orders reducing the rates. The Commissioner of Internal Revenue seeks to tax as income for 1922 the impounded moneys withdrawn in 1919.

In Rate Cases No. 2 the respondent and its subsidiaries began litigation in 1920 attacking the constitutionality of a New York statute known as the Eighty Cent Gas Law (Laws N.Y. 1906, c. 125). The United States District Court granted a temporary restraint against its enforcement and permitted collection of higher rates, requiring the excess to be impounded. Subsequently, in November, 1920 [269 Fed. 452 (D.C.)], an interlocutory order was entered finding the act confiscatory and permitting the impounded moneys to be withdrawn and future collections to be withheld from impounding upon substituting a bond or securities. A final decree in favor of the respondent was entered in May, 1921, and affirmed by the Supreme Court in March, 1922. Newton v. Brooklyn Union Gas Co., 258 U.S. 604. A final decree in favor of one of the subsidiaries, Newton Gas Company, was entered in October, 1921, and the appeal therefrom was dismissed by consent in 1923. 263 U.S. 726. Final decrees in favor of the other subsidiaries were entered in September, 1922, and not appealed. Prior to 1922 and pursuant to court decrees, either interlocutory or final, all moneys in excess of the statutory rate were either withheld or withdrawn from impoundment upon the giving of bonds, with the exception of some $673,000, which was withdrawn in 1922 after the litigation had ended. The Commissioner seeks to tax as 1922 income all moneys in excess of the statutory rate collected during 1920 and 1921.

The question presented is whether the excess moneys represented income to the respondent and its subsidiaries, reporting on the accrual basis, in the year when the rate litigation was finally terminated, as the Commissioner contends, on the ground that until then the right to such moneys was contingent. Rejecting this theory, the Board of Tax Appeals held that the excess moneys constituted income in the years when earned; that is, the years when the gas was furnished and the charges therefor were made against the consumers upon the companies' books. This resulted in allocating to income of years prior to 1922 some $8,600,000, thereby diminishing the tax deficiency which the Commissioner had determined for 1922. The appeal challenges this decision.

Were it not for the case of North American Oil Consol. v. Burnet [supra p. 836], we should unhesitatingly adopt the theory of the Board that the moneys in dispute were income in the year when the service was rendered. To that year was allocated the entire cost of manufacture and distribution of the gas, and to the same year should be attributed the whole price at which it was sold, if the taxpayer's profit on the transaction is to be accurately reflected by the accrual method of bookkeeping. The cases relating to compensation subsequently awarded to railroads for the years of federal control, upon which the Board relied, furnish a persuasive analogy. See Commissioner v. Old Dominion S.S. Co., 47 F.(2d) 148 (C.C.A. 2); Continental Tie & L. Co. v. United States, 286 U.S. 290; compare Uncasville Mfg. Co. v. Commissioner, 55 F.(2d) 893 (C.C.A. 2), cert. denied, 286 U.S. 545. But the *North American Oil* Case gives us pause. There a receiver was appointed to operate certain property pending the outcome of a suit brought to contest the taxpayer's title thereto. Net income produced from the receiver's operation of the property in 1916 was turned over to the taxpayer in 1917, upon the entry of a final decree dismissing the bill of complaint. The decree was appealed, and the litigation was not terminated until 1922. The taxpayer contended that the net profit should be allocated either to 1916 or 1922,

but the court held it to be income for the year 1917, when it was received. While this case casts doubt upon the correctness of the Board's theory that the excess moneys are to be allocated to the years, respectively, when the gas was sold, it strongly supports the decision that final termination of the litigation was not the critical moment. As the Supreme Court said, at page 424 of 286 U.S.:

> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

We think this is conclusive against the Commissioner's contention with respect to the excess moneys which prior to 1922 were withheld or withdrawn from impoundment upon bonds fixed by the court. Such money was income, being payment for service already rendered, and was received by the companies without restriction upon its use. It is true they were subject to a contingent liability to pay back an equivalent amount if the rate litigation ultimately went against them. This liability, however, imposed no restriction upon their use of the money actually in their hands. Nor did the fact that they gave bonds to get it add anything to the contingent liability they were under regardless of such bonds. Termination of the rate litigation merely determined their right to retain income already received. See Board v. Commissioner, 51 F.(2d) 73, 76 (C.C.A. 6). The money received prior thereto cannot be taxed as income of the year 1922.

This disposes of all the moneys involved in Rate Case No. 1 and of all the moneys involved in Rate Case No. 2, except the $673,000 which was withdrawn from impoundment in 1922. This sum represented charges in excess of the statutory rate for gas furnished in 1920 or 1921. As to this the *North American Oil* decision tends to support the Commissioner's contention that the money was income in the year when received. However, two differences in the facts are to be noted: First, the *North American Oil* Case involved only net income resulting from the receiver's operations. The taxpayer there was not required to charge the receiver's expenses to 1916 while crediting his receipts to 1917. Hence there was no such distortion of the taxpayer's income as would result from applying the same rule to the case at bar. Here the entire cost of furnishing gas was charged to the year when the service was rendered, but on the Commissioner's theory only a part of the price charged to and collected from the consumer would be credited as income to that year; the remainder would be credited to income in 1922 and without carrying into that year any part of the expense of earning such income. Obviously this would produce an unfair distortion of the taxpayer's actual profits in each of the years. Secondly, in the *North America Oil* Case no court order was entered in 1916 finding that the taxpayer was entitled to funds in the receiver's hands. As the Supreme Court pointed out (286 U.S. at page 423) there was no constructive receipt of the profits by the taxpayer in 1916, because at no time during that year had it a right to demand that the receiver pay over the money. In the case at bar, however, it was decided in November, 1920, that the statutory rate was confiscatory, and the respondent and its subsidiaries were declared to have a right to receive the impounded income without restriction, provided they filed bonds as security for their conditional liability to return a like sum. Their conditional right to get the impounded money could be turned into an absolute right at their own option. We do not think a taxpayer could alter at will the accrual of income by failing to exercise an option to receive it. A majority of the court believe that these differences in the facts are sufficient to distinguish the *North American Oil* Case, and that the order appealed from should be affirmed in toto. It is so ordered.

L. HAND, Circuit Judge (dissenting in part).

Even when the taxpayer has received the money, it is theoretically possible to treat the item as in suspense, until the right to it has been determined, or as an immediate receipt, with a corresponding deduction, if it is later repaid. But the second was authoritatively laid down in North American Oil Consol. v. Burnet, 286 U.S. 147, as applicable to accounts kept either on an accrual, or a cash, basis. This answers the main issue, and my only difference with my brothers is as to that part of the moneys impounded in Rate Cases No. 2, which was never withdrawn until the suits were determined. If the right to withdraw had been unconditional, perhaps we ought to treat this as though it were already in the coffers of the companies; it was equally available. Indeed, even if the companies had been required to give their individual bonds, these would in substance subject them to no other liability than they were under anyway. But the interlocutory decrees which allowed the withdrawal of $673,000, required them to deposit securities of their own, or the bonds of a surety company. It can scarcely be said that this made the moneys immediately available, like cash on deposit. The condition required them either to turn over equivalent property to the court, or to assume an obligation to the surety, which often demands security. I do not see how such moneys are any more received by the taxpayers, than if the court continued to impound them.

It is sometimes possible, when accounts are kept on an accrual basis, to ignore the conditional character of the right, but that is just what, as I read it, was denied in North American Oil Consol. v. Burnet, in a closely similar situation; the right unaccompanied by possession or its equivalent was too contingent. I agree that in fact the uncertainties were no greater then than those determining the recovery in the Federal Control Cases.* But the distinction between the liquidation of a determined right, and the determination of a disputed right, is familiar throughout the law, though for practical purposes one may be as incalculable as the other. It is reasonable to import this distinction, taken in so many other situations. The "title" to the moneys was in genuine dispute; indeed the company's last efforts had been unsuccessful. To treat the impounded sums as presently accruable appears to me, therefore, to ignore a well recognized classification. As to $673,000 of the moneys in the Rate Cases No. 2, I therefore dissent; otherwise I concur.

NOTE

1. *Accrual of unliquidated amount.* In Globe Corp. v. Commissioner, 20 T.C. 299 (1953), the court was concerned with the proper year for accruing an amount owing to the taxpayer under contracts with the United States for the manufacture of equipment. The contracts provided that in the event the specifications were changed by the United States, the contract prices would be adjusted on a fair and equitable basis by negotiations between the parties. The government ordered changes, in a way that would increase the cost, on certain work that was completed in 1945. The price adjustments were in the process of negotiation during that year; in 1946, an agreement was reached by which the contract prices were increased by about $181,000. The Tax Court upheld the taxpayer's refusal to accrue the additional amount until 1946:

* These cases, some of which are cited in the majority opinion, involved payments under the Transportation Act of 1920, which contained provisions to compensate railroads for losses resulting from government control during World War I. In Continental Tie & Lumber Co. v. United States, 286 U.S. 290 (1932), it was held that a railroad should have accrued in 1920 the amount due to it under the Act, although payment was not made until 1923, because the right to the payment was fixed when the Act took effect in 1920 and data then in the taxpayer's books would have enabled it to compute the amount which it was entitled to receive. — ED.

Until a definite amount was arrived at under the negotiations provided for in the contracts involved herein petitioner had only a claim on a quantum meruit basis for goods and services rendered which, while of value, was too uncertain in amount to accrue. [20 T.C. at 303.]

The court relied in part on Henry Hess Co. v. Commissioner, 16 T.C. 1363, where it had held that the taxpayer was not required to accrue a claim for just compensation arising from the requisition of property by the government until the amount due was fixed by judicial proceedings or otherwise:

> It is not enough to state that the Fifth Amendment to the Federal Constitution guarantees just compensation and thereby fixes taxpayer's right. To this it might, with equal assurance, be rejoined that under our system of jurisprudence and the law as adjudicated by all American courts, every litigant is guaranteed ultimate justice or "equal justice under law." These principles are basic in our system of government. So to state, however, does not devitalize the considerations leading to the holding in innumerable cases that before an amount can be accrued, not only must the right to receive the amount be fixed, but the amount must be reasonably ascertainable. [16 T.C. at 1373-1374.]

With *Globe Corp.*, supra, compare Food Machinery and Chemical Corp. v. United States, 286 F.2d 177 (Ct. Cl. 1960), cert. denied, 368 U.S. 918, where the court held that income derived from the termination of a war contract was accruable in the year of termination on the basis of a settlement with a government representative, although the rate of profit used in the settlement was subject to review by a governmental settlement board in a later year.

DIXIE PINE PRODUCTS CO. v. COMMISSIONER

320 U.S. 516 (1944)

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The question presented concerns the propriety of the respondent's disallowance of a deduction from income which petitioner took in its federal income tax return for 1937.

In 1936 the Mississippi taxing authorities declared that a solvent used by petitioner in its business was gasoline within the meaning of a state law defining gasoline and laying a tax upon its receipt and use. Accordingly a tax was assessed against the petitioner with respect to the receipt and use of the solvent in 1936. Petitioner paid the tax, and, in the same year, brought suit against the Motor Vehicle Commissioner of Mississippi alleging that the solvent was not within the comprehension of the state law and that the Commissioner should be temporarily and permanently enjoined from future collections of tax in respect of it. The Commissioner's demurrer to the complaint was sustained but, on appeal, the Supreme Court of Mississippi decided that, on the pleadings, the solvent was not within the definition of gasoline contained in the state statute. After this decision petitioner denied that it owed, and ceased and refused to pay, any gasoline tax on solvent used by it.

In December, 1937, on advice of counsel, petitioner (which kept its books and filed its federal income tax returns on the accrual basis) made book entries accruing gasoline tax assessed by the Motor Vehicle Commissioner in 1937. The actual accrual entries were made sometime between January 1 and March 15, 1938, as of December 31, 1937, in the amount of approximately $21,000, and petitioner deducted this amount from income in making its 1937 federal income tax return, although the sum had not been, and never was, paid.

In December, 1938 petitioner and the Attorney General of Mississippi filed an agreed statement of facts in the state court suit, and, in the same month, the trial

judge entered a final decree perpetually enjoining the Motor Vehicle Commissioner from assessing gasoline tax on the solvent used by petitioner. This decree was subsequently affirmed by the Supreme Court of Mississippi. In its 1938 federal income tax return petitioner, by way of compensating entry, included the sum of $21,000 as income and as a recovery, in view of the Mississippi trial court's decree of December, 1938.

The sole question is whether the Commissioner was right in disallowing the deduction for the tax year 1937. The Board of Tax Appeals held that he was, and the court below affirmed its decision. We took the case because of a conceded conflict in principle with decisions in other circuits. . . .

The provisions of the Revenue Act of 1936 worked no significant change over earlier Acts respecting the permissible basis of calculating annual taxable income. The applicable principles of accounting on the accrual basis had been adduced and applied by the Board of Tax Appeals in numerous decisions. It has never been questioned that a taxpayer who accounts on the accrual basis may, and should, deduct from gross income a liability which really accrues in the taxable year. It has long been held that, in order truly to reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid; and this cannot be the case where the liability is contingent and is contested by the taxpayer. Here the taxpayer was strenuously contesting liability in the courts and, at the same time, deducting the amount of the tax, on the theory that the state's exaction constituted a fixed and certain liability. This it could not do. It must, in the circumstances, await the event of the state court litigation and might claim a deduction only for the taxable year in which its liability for the tax was finally adjudicated.

To this effect are the decisions of the Board of Tax Appeals in numerous cases, and the instant decision was in line with earlier rulings as to proper tax accounting practice. Since the Board applied the correct rule of law, its determination that the item in question was not properly deducted on the accrual basis is entitled to the finality indicated by Dobson v. Helvering, 320 U.S. 489. The court below properly refused to disturb the Board's determination.

Affirmed.

NOTE

1. *Effect of prior transaction.* Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944), involved a taxpayer who contested the constitutionality of the processing tax levied by the Agricultural Adjustment Act of 1933. The taxpayer brought suit to enjoin collection and the court ordered the amount of the tax to be paid into a depository pendente lite. In 1935 the taxpayer made deposits in the amount of about $93,000 and, in computing the prices to be charged its customers, it considered the tax as a cost of production. Some of the customers were advised, however, that the taxpayer would treat them "fairly" in the event the tax was held unconstitutional, although no enforceable obligations were assumed. In 1936 the tax was held unconstitutional and the court ordered the deposited funds to be returned to the taxpayer, though only after claims to the same funds had been interposed by certain customers and rejected by the court. In the years 1936-1938 the taxpayer refunded about $45,000 to certain of its customers, those whose goodwill it wished to cultivate. The taxpayer sought to deduct for the year 1935 the $45,000 paid out in 1936-1938 on the theory that income would be distorted if the gross sales price of its product was reported in 1935 and the refunds were deducted in later years. (An effort was also made to obtain a deduction for the full amount of the taxes, but this was not the taxpayer's primary contention, and the *Dixie Products Co.* case, decided while its case was pending before the Supreme Court, disposed of this issue.) The taxpayer relied on a proviso of §43 of the 1939 Code that deductions and credits were to be taken in the year

paid or accrued, depending on the taxpayer's method of accounting, "*unless* in order to clearly reflect the income the deductions or credits should be taken as of a different period." * The Supreme Court rejected this argument, saying:

> In short, the petitioner's position is that the Commissioner and the Board of Tax Appeals are authorized and required to make exceptions to the general rule of accounting by annual periods wherever, upon analysis of any transaction, it is found that it would be unjust or unfair not to isolate the transaction and treat it on the basis of the long term result. We think the position is not maintainable.
>
> The Revenue Act of 1921, in Secs. 214(a)(6) and 234(a)(4) authorized the Commissioner to allow the deduction of losses in a year other than that in which sustained when, in his opinion, that was necessary clearly to reflect income. The qualifying clause of Sec. 43 was first added as Sec. 200(d) of the Revenue Act of 1924. The reports of both House and Senate Committees concerning this change said: "The proposed bill extends that theory to all deductions and credits. The necessity for such a provision arises in cases in which a taxpayer pays in one year interest or rental payments or other items for a period of years. If he is forced to deduct the amount in the year in which paid, it may result in a distortion of his income which will cause him to pay either more or less taxes than he properly should." (1939-1 C.B. (Part 2) 249.)
>
> From these reports it is clear that the purpose of inserting the qualifying clause was to take care of fixed liabilities payable in fixed installments over a series of years. For example, a tenant would not be compelled to accrue, in the first year of a lease, the rental liability covering the entire term nor would he be permitted, if he saw fit to pay all the rent in advance, to deduct the whole payment as an expense of the current year. But we think it was not intended to upset the well-understood and consistently applied doctrine that cash receipts or matured accounts due on the one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash basis nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer. [321 U.S. at 285-286.]

If §1341 had been in effect for the taxable years in question in *Security Flour Mills*, would it have applied?

2. *The taxpayer who guesses wrong.* See Keller-Dorian Corp. v. Commissioner, 153 F.2d 1006 (2d Cir. 1946), involving a taxpayer who imported certain goods in the years 1936-1940 and paid customs duties to the United States on the basis of values approved by the customs authorities. Subsequently the goods were reappraised and additional amounts were paid as duties in 1941 and 1942 as a result of the reappraisals. The court held that the additional payments could not be deducted in 1941 and 1942. (Apparently the earlier years were closed by the statute of limitations.) It said:

> The Tax Court ruled that customs duties are taxes and must be treated for income tax purposes in the same manner as any other taxes; that since the petitioner reported on the accrual basis, it was obliged to accrue the duties in the taxable year in which the merchandise was imported, if all the facts had occurred in that year to fix the amount and the fact of the taxpayer's liability; and that the record did not show that such facts had not then occurred. We see no escape from this conclusion. The liability of an importer for customs duties accrues when the goods arrive at the port of entry. . . . The petitioner failed to show that the reappraisals which resulted in the additional customs duties were not required to correct errors in the original computations. This court has held that if the correct amount of a tax is ascertainable in the year when the liability accrues, even though it was not in fact then ascertained, the later correction of the error in computation does not entitle the taxpayer (on accrual basis) to take a deduction in the year when the additional tax is paid.

* The corresponding provision of the 1954 Code, §461(a), is worded somewhat differently, but, since §446(b) provides that the method of accounting must "clearly reflect income," presumably no substantive change was intended.

Uncasville Mfg. Co. v. Commissioner, 2 Cir., 55 F.2d 893, 895, certiorari denied 286 U.S. 545. . . . This principle appears to us conclusive of the case at bar. Since the record does not show why reappraisals were required in 1940 and 1941 we must assume that the customs officials acted lawfully in requiring them; that means, since there was no change in the statute, that a basis of computation was originally applied which the officials later discovered to have been erroneous. The *Uncasville* case establishes that such a legal error cannot be used by a taxpayer as a basis for saying that he could not have known the correct amount of the taxes (or customs duties) in the earlier years when they accrued. [153 F.2d at 1007.]

Could the taxpayer have accrued in 1941 and 1942 the amounts actually due if he paid smaller amounts in the hope that the lower values would be accepted by the customs officials?

See also Baltimore Transfer Co. v. Commissioner, 8 T.C. 1 (1947); Rev. Rul. 55-731, 1955-2 C.B. 254.

UNITED STATES v. CONSOLIDATED EDISON CO.

366 U.S. 380 (1961)

MR. JUSTICE WHITTAKER delivered the opinion of the Court.

Respondent brought this action in the United States District Court for the Southern District of New York to recover a claimed overpayment of federal income taxes for the year 1951. It keeps its books and files its returns on a calendar year-accrual basis. The case turns on the correct determination of the proper year of accrual and deduction of certain contested real estate taxes. Specifically, the question is whether the contested part of a real estate tax *accrued* (1) in the year it was assessed and, for the purpose — and as the only mode recognized by the local law — of avoiding seizure and sale of the property for the contested tax while the contest was pending, was "paid" by the taxpayer, or (2) in the year the contest was finally determined.

The District Court, following the holding of the Court of Claims in Consolidated Edison Co. v. United States [135 F. Supp. 881 (Ct. Cl. 1955), cert. denied, 351 U.S. 909], that such a "payment" of the tax "accrues the item even though payment is made under protest and even though litigation is started within the taxable year to obtain repayment," held, without opinion, that the contested part of the tax accrued in the year of the "payment." On appeal, the Court of Appeals, by a divided court, held that the contested part of the tax accrued in the year the contest was finally determined, and reversed the judgment. 279 F.2d 152. It reasoned that inasmuch as respondent was "keeping its books on the accrual basis," the contested part of the tax accrued "only when all events [had] occurred which determine[d] the fact and amount of the tax liability." Id., at 155. To resolve the conflict between the decision below and Consolidated Edison Co. v. United States, supra, we granted certiorari. 364 U.S. 890.

During the years involved — 1946 through 1950 — respondent owned numerous tracts of real estate in New York City which were subject to annual local property taxes. Under the New York law, the City Council annually fixes the tax rate, and the City Tax Commission annually fixes the property valuations. Thus the amount of the tax on each tract is determined by multiplying the valuation by the tax rate. The tax rate is not contestable, but a timely application (commonly called a "protest") may be made to the City Tax Commission to correct an erroneous valuation. Among other things, the protest must state the amount which the taxpayer "consider[s] was the full value of the property on January 25 [of the current] year" thus to establish the amount of the tax that is not contested. Upon exhaustion of this administrative procedure, a review of the Commission's determination may be had by a judicial proceeding, commonly called a certiorari pro-

ceeding, in the State Supreme Court, which is the taxpayer's sole and exclusive remedy. But the institution of such a suit does not stay or suspend the maturity of the tax bill, the accrual of 7% interest on it, nor the seizure and sale of the property to satisfy the tax lien. Thus, to obtain review, the taxpayer must either "pay" the tax or suffer the interest penalty and run the risk of seizure and sale of its property.

Though taxes for each of five years on hundreds of tracts are involved and the aggregate amount is very substantial, the parties very commendably stipulated in the District Court that the facts are sufficiently reflected, for the purposes of this suit, in the following simplified example:

In each of the years 1946 through 1950, respondent was notified of a tentative valuation which, at the established tax rate, would produce a tax of $100. Respondent then timely filed a bona fide protest (in respect of many, but not nearly all, of its tracts) stating a valuation which, at the established tax rate, would produce a tax of $85, and asking that the balance of the proposed valuation be stricken as excessive. After hearing, the Commission rejected the protest, and an assessment in the amount of $100 was made. Thereupon respondent, under protest and for the honestly stated purpose of avoiding the interest penalty and the seizure and sale of its property while it was contesting the Commission's valuation by certiorari proceedings in the state court, remitted to the city cash in an amount equal to the tax of $100, and immediately thereafter commenced a certiorari proceeding in the proper court, in which it again admitted liability for a tax in the amount of $85, but denied all liability for any tax in excess of that amount. In December 1951, the court, upon the consent of the parties to the action, entered its order in (each of) the certiorari proceedings fixing respondent's tax liability at $95, and thereupon the city forthwith returned $5 to respondent.

Although it was then engaged in a contest with the Commissioner in the Court of Claims over an identical question, namely, the proper income tax treatment to be accorded the $15 for each of the years 1938, 1939 and 1941 — which issue was decided by the Court of Claims in December 1955 in favor of the Government, Consolidated Edison Co. v. United States, supra — respondent, in terms of the illustrative example, accrued on its books and deducted on its federal income tax returns, for each of the years 1946 through 1950, the full $100; and in its return for the year 1951 — in which year the real estate tax liability was determined to be $95 — respondent failed to deduct the $10 from, and included the $5 in, its gross income for that year.[1]

Believing that this treatment of the $15 in 1951 was erroneous and resulted in its paying a lesser amount of federal income taxes in each of the years 1946 through 1950, and more in the year 1951, than it should have paid,[2] respondent filed in February 1955 its claim for refund of so much of its 1951 income taxes as resulted (1) from its failure to deduct the $10 of real estate tax that was deter-

[1] Respondent asserts that this treatment of the $15 in its 1951 federal income tax return was made under compulsion of the Commissioner's erroneous G.C.M. 25298, issued directly to it in 1947 (C.B. 1947-2, 39), saying, "a contested tax liability accrues not later than time of payment, notwithstanding continuation of contest. The accrual basis of accounting relates to the deductibility of unpaid items," and that the Commissioner insisted upon that treatment, despite his modification thereof in Mim. 6444 (C.B. 1949-2, 11), saying in pertinent part, that "payment of [a] contested tax liability as a prerequisite for appeal is not deductible under G.C.M. 25298."

[2] The economic consequences to the parties arise from the fact that corporate income tax rates (normal plus surtax) were increased from 38% in 1946 to 50¾% in 1951, and, in this particular instance, more revenue would be produced by taking the deduction in 1946-1950 than in 1951. The taxpayer recognizes that, if its position be sustained, the Commissioner will have one year after entry of final judgment herein to reaudit the taxpayer's 1946-1950 returns and to assess deficiencies based upon deduction of the $15 in those years, in accordance with the provisions of §§1311-1315 of the Internal Revenue Code of 1954.

mined, in that year, to be valid, and (2) from its inclusion in gross income of the $5 returned to it in that year. Upon rejection of that claim, respondent timely brought this action in the District Court to recover the refund claimed, and obtained the result already stated. . . .

Thus the very narrow issue here is whether the remittance admitted liability for, and constituted "payment" and "satisfaction" of, the contested part of the assessment and thereby rendered it accruable in the year of the remittance. Like the Court of Appeals, we think the respondent is right in its contention, and that $10 of the contested $15 of the tax accrued when liability in that amount was finally determined by the New York court in 1951, and that the $5, for which respondent was by that judgment held not liable, and which was returned to it by the city, was not income to respondent in 1951.

Although the Government attempts to distinguish the *Anderson, Dixie Pine* and *Security Mills* cases [269 U.S. 422; 320 U.S. 516; 321 U.S. 281] on the ground that "payment" of the contested taxes had not been made in those cases, it primarily relies on the decisions of the Court of Claims in Chestnut Securities Co. v. United States, 104 Ct. Cl. 489 and Consolidated Edison Co. v. United States, 133 Ct. Cl. 376.

The *Chestnut Securities* case turned on the question whether certain judicially contested state income taxes (for the years 1936-1938) accrued when they were paid in 1940, as claimed by the accrual-basis taxpayer, or when the final judgment upholding their validity was rendered in 1942, as contended by the Government. Squarely contrary to its contention here, the Government, relying on Security Mills Co. v. Commissioner, supra, there contended that "since the [taxpayer's] accounts were kept and its tax returns made on the accrual basis, it could not take its deduction for the taxes . . . paid to the State . . . until the year 1942, when its suit for their return was finally decided adversely to it." On the facts of that case, the Court of Claims held that "the Government [was] wrong" in that contention. Although, in full consonance with the *Security Mills* case, the Court of Claims said "[o]ne is not entitled to accrue a debt or other liability which is asserted against him but which he disputes and litigates, until the litigation is concluded," it went on to say "[b]ut if a liability is asserted against him and he pays it, though under protest, and though he promptly begins litigation to get the money back, the status of the liability is that it has been discharged by payment. It is hardly conceivable that a liability asserted against him, which he has discharged by payment, has not yet 'accrued' within the meaning of the tax laws and the terminology of accounting. Accrual, from the debtor's standpoint, precedes payment, and does not survive it." 104 Ct. Cl., at 494-495. And after pointing to this Court's use of the phrase "and failed to pay" in its holding in the *Security Mills* case that "Since [the taxpayer] denied liability for, and failed to pay, the tax during the taxable year 1935, it was not in a position in its tax accounting to treat the Government's claim as an accrued liability," the Court of Claims concluded: "In the instant case the taxpayer denied liability, but paid. We think it thereby 'accrued' the taxes and interest, if accrual is requisite at all, in the case of the debtor, when actual payment has occurred." 104 Ct. Cl., at 495.

The *Consolidated Edison* case involved the same parties, facts and questions as the present case, though in respect to earlier tax years. Although recognizing that this Court's opinions in Security Mills Co. v. Commissioner, supra, and Dixie Pine Products Co. v. Commissioner, supra, had "settled" the law to be "that a taxpayer may not accrue an expense when he is denying liability and refusing and contesting its payment," the Court of Claims rejected, as "not necessarily true," the taxpayer's argument "that there must therefore be an admission or absence of denial of liability before an item may be accrued, and that the pay-

ment of the liability within the taxable year has no effect on its accrual since payment was made under protest and litigation was immediately started to obtain a repayment" (133 Ct. Cl., at 382); and, purporting to follow, but seemingly departing from, its decision in the *Chestnut Securities* case, the Court concluded "that payment of an item *which is otherwise accruable in the taxable year* accrues the item even though payment is made under protest and even though litigation is started within the taxable year to obtain repayment." 133 Ct. Cl., at 383-384. (Emphasis added.) On that conclusion the Court rendered judgment for the Government.

Just what the Court meant by the phrase we have italicized was not explained, but it is evident that if the tax item was "otherwise accruable in the taxable year," payment — whether of a character that would constitute an admission of the asserted liability or a mere deposit to enable contest of the liability — certainly would not render the item nonaccruable; and if, in the absence of payment, the item was "otherwise accruable in the taxable year," payment would be immaterial, or at least unnecessary, to the question of accruability. It thus appears that the Court's judgment was contrary to its rule in that case, for, although it regarded the remittance as "payment" of the asserted tax liability, admittedly the contested part of the tax was not "*otherwise* accruable in the taxable year."

Disagreeing with the conclusion of the Court of Claims in the *Consolidated Edison* case, the Court of Appeals concluded, we think correctly, that the question of accruability of the tax — apart from the issue respecting "payment" and "satisfaction" — was governed by the "all events" test established by this Court in United States v. Anderson [269 U.S. at 441], as amplified and affirmed in Dixie Pine Co. v. Commissioner, supra, and reaffirmed as amplified in Security Mills Co. v. Commissioner, supra.

As to whether respondent's remittance of the full $100 to the city, in the circumstances of this case, constituted an admission of liability for, and a "payment" and "satisfaction" of, the contested $15 of the assessment, the Court of Appeals recognized that this Court's opinions in the *Anderson, Dixie Pine* and *Security Mills* cases refer to the fact that "payment" of the taxes sought to be deducted in those cases had not been made by the taxpayers, but it thought, and we agree, that those references were made only for the sake of complete accuracy to an important but, so far as those cases were concerned, a collateral matter, and not to the determinative considerations of those cases, which were the "all events" test as they state it.

"Payment" is not a talismanic word. It may have many meanings depending on the sense and context in which it is used. As correctly observed by the Court of Appeals, "A payment may constitute a capital expenditure, an exchange of assets, a prepaid expense, a *deposit,* or a current expense," and "[w]hen the exact nature of the payment is not immediately ascertainable because it depends on some future event, such as the outcome of litigation, its treatment for income tax purposes must await that event." 299 F.2d, at 156. (Emphasis added.)

Of course, an unconditional "payment" made by a taxpayer in apparent "satisfaction" of an asserted matured tax liability is, without more, plain and persuasive evidence, at least against the taxpayer, that "all the events [have] occur[red] which fixed the amount of the tax and determine the liability of the taxpayer to pay it," United States v. Anderson, supra, at 441, and that the item so paid and satisfied has accrued.

But where, as stipulated by the parties in this case, the remittance or "payment" did not admit, but specifically denied, liability for, and was not intended to satisfy, the contested $15 of the assessment, but was, in effect, a mere deposit, "in the nature of a cash bond for the payment of [so much, if any, of the contested] taxes

[as might] thereafter be found to be due" (Rosenman v. United States, 323 U.S. 658, 662, and see Lewyt Corp. v. Commissioner, 215 F.2d 518, 523 (C.A. 2d Cir.)), and was made for the sole purpose of staying — there being no other way to stay — an otherwise possible seizure and sale of the property for the contested tax while its validity was being honestly and diligently contested in the only way allowed by the law of the State, it will not do to say that the taxpayer has made an unconditional "payment" in apparent "satisfaction" of the contested part of an asserted matured tax liability, and thereby rendered it immediately accruable.

We therefore conclude that $10 of the contested $15 tax liability accrued not in the year of the remittance, but in 1951 when the New York court entered its final order determining that liability; and that the $5, for which respondent was held not liable by that judgment and which was returned to it by the city, was not income to respondent in 1951.

Affirmed.

NOTE

1. *Implications of Consolidated Edison.* If the outcome of the state court proceeding had been a refund of $20, how would the liability and refund be reflected on the federal tax return? What would have been the proper treatment of the payment of $100 in 1946 if the taxpayer had not filed a protest until 1947? Would this depend on whether it intended at the time of payment to file a timely protest? What if the taxpayer paid the amount assessed in 1946, intending to file a claim for refund only if a similarly situated taxpayer was successful in a pending suit?

2. *Legislative rejection of Consolidated Edison.* In 1964, Congress enacted §461(f) to overrule the *Consolidated Edison* case, the Senate Finance Committee explaining this action as follows:

> (a) *Present law.* — Prior to the decision in the *Consolidated Edison* case the Internal Revenue Service generally held that the payment of a contested tax liability resulted in the tax being considered as deductible even though the tax was still being vigorously denied and contested.[1] In the *Consolidated Edison* case decided in 1961 the Supreme Court held that a contested tax even when paid does not accrue as a deduction for income tax purposes until the contest is terminated. It was held that the tax was not deductible until after the contest was settled because all of the events which would determine whether or not the amount would ultimately have to be paid would not be determined until that time.
>
> (b) *General reasons for provision.* — Although your committee does not question the legal doctrine laid down by the Supreme Court in the *Consolidated Edison* case, it believes that it is unfortunate to deny taxpayers a deduction with respect to an item where the payment has actually been made, even though the liability is still being contested either as to amount or as to the item itself. The objective of the reporting of items of income and deduction under the internal revenue laws generally is to realistically and practically match receipts and disbursements attributable to specific taxable years. The internal revenue laws contain a number of adjustments designed to accomplish this result. Your committee believes that allowing the deduction of items in the year paid, even though they are still being contested in the courts or otherwise, more realistically matches these deductions up with the income to which they relate than would the postponement of the deduction, perhaps for several years, until the contest is settled. To the extent that deductions are allowed under this rule and then subsequently as a result of the contest the items were found not to be payable, adjustment can be made for this overstatement of the deduction by the inclusion of the overstatement in income in the year in which the amount of the liability is finally determined.
>
> (c) *General explanation of provision.* — In view of the above considerations, your committee has amended the provision of existing law which specifies the year for the taking

[1] This is the general rule laid down in *Chestnut Securities Co. v. United States* (62 F. Supp. 574 (1945)) which the Internal Revenue Service accepted in GCM 25298 (1947-2 CB 39).

of deductions or credits generally. The amendment provides that if a taxpayer contests an asserted liability, such as a tax assessment, but makes a payment in satisfaction of this liability and the contest with respect to the liability exists after the payment, then the item involved is to be allowed as a deduction or credit in the year of the payment. This is based upon the assumption that the deduction or credit in this case would have been allowed in the year of payment, or perhaps in an earlier year when it would have been accrued, had there been no contest.

The treatment provided here can be illustrated by an example. Assume that in 1965 a $100 liability is asserted against a business which it pays at that time but contests the liability in a court action. Assume further that in 1967 the court action is settled for $80. Under present law, before the enactment of this provision, the deduction of $80 would be allowed in 1967. Under your committee's action, the taxpayer could claim a $100 deduction in 1965 but then in 1967 would have to take $20 into income except as provided in section 111 of the code, relating to recovery of bad debts, prior taxes, and delinquency amounts.

In those cases where payment is not made until after the contest is settled, this does not prevent an accrual basis taxpayer from accruing the deduction or credit in an earlier year in which the contest is settled.

A similar amendment to that described above is also made to the Internal Revenue Code of 1939. [S. Rept. No. 830, 88th Cong., 2d sess., pp. 100-101.]

3. *References.* Freeman, Tax Accrual Accounting for Contested Items, 56 Mich. L. Rev. 727 (1958); Raum, Current Developments on Accrual of Taxes, 12 N.Y.U. Inst. on Fed. Taxation 647 (1954); Note, Accrual of Tax Deficiencies and Recoveries, 58 Colum. L. Rev. 372 (1958).

2. *The Use of Hindsight*

BURNET v. SANFORD & BROOKS CO.

282 U.S. 359 (1931)

MR. JUSTICE STONE delivered the opinion of the Court.

In this case certiorari was granted to review a judgment of the Court of Appeals for the Fourth Circuit, 35 F.(2d) 312, reversing an order of the Board of Tax Appeals, 11 B.T.A. 452, which had sustained the action of the Commissioner of Internal Revenue in making a deficiency assessment against respondent for income and profits taxes for the year 1920.

From 1913 to 1915, inclusive, respondent, a Delaware corporation engaged in business for profit, was acting for the Atlantic Dredging Company in carrying out a contract for dredging the Delaware River, entered into by that company with the United States. In making its income tax returns for the years 1913 to 1916, respondent added to gross income for each year the payments made under the contract that year, and deducted its expenses paid that year in performing the contract. The total expenses exceeded the payments received by $176,271.88. The tax returns for 1913, 1915, and 1916 showed net losses. That for 1914 showed net income.

In 1915 work under the contract was abandoned, and in 1916 suit was brought in the Court of Claims to recover for a breach of warranty of the character of the material to be dredged. Judgment for the claimant, 53 Ct. Cl. 490, was affirmed by this Court in 1920. United States v. Atlantic Dredging Co., 253 U.S. 1. It held that the recovery was upon the contract and was "compensatory of the cost of the work, of which the government got the benefit." From the total recovery, petitioner received in that year the sum of $192,577.59, which included the $176,271.88 by which its expenses under the contract had exceeded receipts from it, and accrued interest amounting to $16,305.71. Respondent having failed to include

these amounts as gross income in its tax returns for 1920, the Commissioner made the deficiency assessment here involved, based on the addition of both items to gross income for that year.

The Court of Appeals ruled that only the item of interest was properly included, holding, erroneously as the government contends, that the item of $176,271.88 was a return of losses suffered by respondent in earlier years and hence was wrongly assessed as income. Notwithstanding this conclusion, its judgment of reversal and the consequent elimination of this item from gross income for 1920 were made contingent upon the filing by respondent of amended returns for the years 1913 to 1916, from which were to be omitted the deductions of the related items of expenses paid in those years.* Respondent insists that as the Sixteenth Amendment and the Revenue Act of 1918, which was in force in 1920, plainly contemplate a tax only on net income or profits, any application of the statute which operates to impose a tax with respect to the present transaction, from which respondent received no profit, cannot be upheld.

If respondent's contention that only gain or profit may be taxed under the Sixteenth Amendment be accepted without qualification, see Eisner v. Macomber; Doyle v. Mitchell Brothers Co., 247 U.S. 179, the question remains whether the gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as is pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.

All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year, or, at the option of the taxpayer, the particular fiscal year which he may adopt. . . .

That the recovery made by respondent in 1920 was gross income for that year . . . cannot, we think, be doubted. The money received was derived from a contract entered into in the course of respondent's business operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. See Doyle v. Mitchell Brothers Co., supra, page 185 of 247 U.S.

That such receipts from the conduct of a business enterprise are to be included in the taxpayer's return as a part of gross income, regardless of whether the particular transaction results in net profit, sufficiently appears from the quoted words of Section [61(a)] and from the character of the deductions allowed. Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.

Bowers v. Kerbaugh-Empire Co., 271 U.S. 170, on which respondent relies, does not support its position. In that case the taxpayer, which had lost, in business, borrowed money, which was to be repaid in German marks, and which was later

* Cf. the "tax benefit" approach in the *Perry* case, supra page 75. — Ed.

repaid in depreciated currency, had neither made a profit on the transaction, nor received any money or property which could have been made subject to the tax.

But respondent insists that if the sum which it recovered is the income defined by the statute, still it is not income, taxation of which without apportionment is permitted by the Sixteenth Amendment, since the particular transaction from which it was derived did not result in any net gain or profit. But we do not think the amendment is to be so narrowly construed. A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss; but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis. The computation of income annually as the net result of all transactions within the year was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment. See Bowers v. Kerbaugh-Empire Co., supra, page 174 of 271 U.S.; Pacific Insurance Co. v. Soule, 7 Wall. 433; Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 630. It is not to be supposed that the amendment did not contemplate that Congress might make income so ascertained the basis of a scheme of taxation such as had been in actual operation within the United States before its adoption. While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. If losses from particular transactions were to be set off against gains in others, there would still be the practical necessity of computing the tax on the basis of annual or other fixed taxable periods, which might result in the taxpayer being required to pay a tax on income in one period exceeded by net losses in another.

Under the statutes and regulations in force in 1920, two methods were provided by which, to a limited extent, the expenses of a transaction incurred in one year might be offset by the amounts actually received from it in another. One was by returns on the accrual basis . . . The other was under Treasury Regulations [§1.451-3] . . . providing that in reporting the income derived from certain long term contracts, the taxpayer might either report all of the receipts and all of the expenditures made on account of a particular contract in the year in which the work was completed, or report in each year the percentage of the estimated profit corresponding to the percentage of the total estimated expenditures which was made in that year. . . .

The assessment was properly made under the statutes. Relief from their alleged burdensome operation which may not be secured under these provisions, can be afforded only by legislation, not by the courts.

Reversed.

NOTE

1. *Carryover of losses.* Note the Court's statement: "The computation of income annually as the net result of all transactions within the year was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment." Could Congress require income to be computed on a monthly or weekly basis and deny any carryover of losses between such periods? See §6851(a), permitting the Internal Revenue Service to terminate a taxpayer's taxable year at any time, if collection of the tax is in jeopardy, and to require immediate payment of tax on the income of the period so terminated.

Statutory provision for the carryover of losses appeared for the first time in the Revenue Act of 1918, and only losses occurring subsequent to its enactment qualified. Would the taxpayer have been materially aided if §172 of the present Code had been in effect for the years in question?

2. *Unprofitable transactions.* Bowers v. Kerbaugh-Empire Co., distinguished by the Court, involved this situation: The taxpayer borrowed funds from a German bank prior to World War I. The lender transmitted marks to its New York representative, who converted the marks into dollars and advanced the dollars to the taxpayer. The taxpayer agreed to repay the loan in marks or in their equivalent in gold coin of the United States. As of March 31, 1915, the balance due was 3,216,445 marks. In 1921, the taxpayer paid off the balance (to the Alien Property Custodian, the successor in title to the lender) with dollars at the then rate of exchange, 2½ cents per mark, an amount far less than the value of the marks when borrowed. The difference between the amount in dollars received under the loan and the amount paid to discharge it was about $685,000. The borrowed funds had been lost by the taxpayer in the years 1913-1918. The Court held that the difference between the dollars received by the taxpayer and the amount paid in 1921 was not income:

> The transaction here in question did not result in gain from capital and labor, or from either of them, or in profit gained through the sale or conversion of capital. The essential facts set forth in the complaint are the loans in 1911, 1912, and 1913, the loss in 1913 to 1918 of the moneys borrowed, the excess of such losses over income by more than the item here in controversy, and payment in the equivalent of marks greatly depreciated in value. The result of the whole transaction was a loss. . . . When the loans were made and notes given, the assets and liabilities of defendant in error were increased alike. The loss of the money borrowed wiped out the increase of assets, but the liability remained. The assets were further diminished by payment of the debt. The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit, or income. [271 U.S. 170, 175 (1925).]

Does the *Sanford & Brooks Co.* case distinguish the *Kerbaugh-Empire Co.* case on the ground that the repayment of a loan for less than face value cannot produce income? See what was said of *Kerbaugh-Empire* in the *Kirby Lumber* case, supra page 89, and in Bradford v. Commissioner, supra page 89. See also Church's English Shoes, Ltd. v. Commissioner, 229 F.2d 957 (2d Cir. 1956); Magill, Taxable Income 245-254 (rev. ed. 1945).

HEALY v. COMMISSIONER

345 U.S. 278 (1953)

MR. CHIEF JUSTICE VINSON delivered the opinion of the Court.

The income tax liability of three individual taxpayers for a given year is here before the Court. Only a single question, common to all the cases, is involved. The Tax Court held a view favorable to the taxpayers. The Commissioner of Internal Revenue sought review before the appropriate Courts of Appeals. As to two of the taxpayers, the Court of Appeals for the Second Circuit reversed, while

the Court of Appeals for the Sixth Circuit took a contrary view of the law. We granted certiorari to resolve the conflict.

All controlling facts in the three situations are similar. Each taxpayer reports his income on the cash receipts and disbursements method. Each, in the respective years involved, received a salary from a closely held corporation in which he was both an officer and a stockholder. The full amount of salary so received was reported as income for the year received. Subsequently, after audit of the corporate returns, the Commissioner disallowed the deduction by the corporations of parts of the salaries as exceeding reasonable compensation. As a result, deficiencies in income taxes were determined against the corporations. The Commissioner also determined that the officers were liable as transferees under [§6901(a](1)], for the corporate deficiencies.* The receipt of excessive salary was the transfer upon which the transferee liability was predicated. As a result of either litigation or negotiation, various amounts became established as deficiencies of the corporations and as transferee liabilities of each of the three officers. In each case, the entire process of determining these amounts — from the start of the audit by agents of the Commissioner to the final establishment of the liabilities — occurred after the end of the year in which the salary was received and reported.

The question before the Court is whether part of the salary should be excluded from taxable income in the year of receipt since part was excessive salary and led to transferee liability for the unpaid taxes of the corporations. The taxpayers contend that an adjustment should be made in the year of original receipt of the salary; the Government that an adjustment should be made in the year of payment of the transferee liability.

One of the basic aspects of the federal income tax is that there be an annual accounting of income. Each item of income must be reported in the year in which it is properly reportable and in no other. For a cash basis taxpayer, as these three are, the correct year is the year in which received.

Not infrequently, an adverse claimant will contest the right of the recipient to retain money or property, either in the year of receipt or subsequently. In North American Oil Consolidated v. Burnet, 1932, 286 U.S. 417, we considered whether such uncertainty would result in an amount otherwise includible in income being deferred as reportable income beyond the annual period in which received. That decision established the claim of right doctrine "now deeply rooted in the federal tax system." The usual statement of the rule is that by Mr. Justice Brandeis in the *North American Oil* opinion:

> If a taxpayer receives earnings under a claim of right and without restrictions as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent. (286 U.S. at page 424.)

The phrase "claim of right" is a term known of old to lawyers. Its typical use has been in real property law in dealing with title by adverse possession, where the rule has been that title can be acquired by adverse possession only if the occupant claims that he has a right to be in possession as owner. The use of the term in the field of income taxation is analogous. There is a claim of right when funds are received and treated by a taxpayer as belonging to him. The fact that subsequently the claim is found to be invalid by a court does not change the fact that the claim did exist. A mistaken claim is nonetheless a claim, United States v. Lewis [supra p. 103].

However, we are told that the salaries were not received as belonging to the tax-

* On transferee liability, see page 929 infra. — Ed.

payers, but rather they were received by the taxpayers as "constructive trustees" for the benefit of the creditors of the corporation. Admittedly, receipts by a trustee expressly for the benefit of another are not income to the trustee in his individual capacity, for he "has received nothing . . . for his separate use and benefit," Eisner v. Macomber.

We do not believe that these taxpayers were trustees in the sense that the salaries were not received for their separate use and benefit. Under the equitable doctrine that the funds of a corporation are a trust fund for the benefit of creditors, a stockholder receiving funds without adequate consideration from an insolvent corporation may be held, in some jurisdictions, to hold the funds as a constructive trustee. So it was that these taxpayers were declared constructive trustees and were liable as transferees in equity.* A constructive trust is a fiction imposed as an equitable device for achieving justice. It lacks the attributes of a true trust, and is not based on any intention of the parties. Even though it has a retroactive existence in legal fiction, fiction cannot change the "readily realizable economic value" [1] and practical "use and benefit" [2] which these taxpayers enjoyed during a prior annual accounting period, antecedent to the declaration of the constructive trust.

We think it clear that the salaries were received under a claim of individual right — not under a claim of right as a trustee. Indeed one of the parties concedes, as is manifestly so, that the reporting of the salary on the income tax returns indicated that the income was held under a claim of individual right. The taxpayers argue that the salary was subject to a restriction on its use.[3] Since all the facts which ultimately gave rise to the transferee liability were in existence at the end of the taxable year, we are told those facts were a legal restriction on the use of the salary. Actually it could not have been said at the end of each of the years involved that the transferee liability would materialize. The Commissioner might not have audited one or all of these particular returns; the Commissioner might not have gone through the correct procedure or have produced enough admissible evidence to meet his burden of proving transferee liability;[4] or, through subsequent profitable operations, the corporations might have been able to have paid their taxes obviating the necessity of resort to the transferees.[5]

There is no need to attempt to list hypothetical situations not before us which put such restrictions on use as to prevent the receipt under claim of right from giving rise to taxable income. But a potential or dormant restriction, such as here involved, which depends upon the future application of rules of law to present facts, is not a "restriction on use" within the meaning of North American Oil v. Burnet, supra.

The inequities of treating an amount as income which eventually turns out not to be income are urged upon us. The Government concedes that each of these taxpayers is entitled to a deduction for a loss in the year of repayment of the

* Does the fact that part of the salaries were disallowed as deductions under §162 ipso facto establish that the recipients were constructive trustees, once it is established that the paying corporation was insolvent? — Ed.

1 Rutkin v. United States [supra p. 105].

2 Eisner v. Macomber [supra p. 56].

3 The rule announced in North American Oil v. Burnet, supra, requires a receipt without "restriction on use" as well as under a claim of right.

4 [Section 6902(a)] imposes upon the Commissioner the burden of proving transferee liability. This may be contrasted to the rule that normally the burden of proof is on the taxpayer contesting the determination of the Commissioner. I.R.C. [§7453]; Rule 32, Tax Court of United States.

5 Transferee liability is secondary to the primary liability of the transferor. To sustain transferee liability the Commissioner must prove that he is unable to collect the deficiency from the transferor. 9 Mertens, Law of Federal Income Taxation, §53.29.

amount earlier included in income. In some cases, this treatment will benefit the taxpayer; in others it will not. Factors such as the tax rates in the years involved and the brackets in which the income of the taxpayer falls will be controlling. A rule which required that the adjustment be made in the earlier year of receipt instead of the later year of repayment would generally be unfavorable to taxpayers, for the statute of limitations would frequently bar any adjustment of the tax liability for the earlier year. Congress has enacted an annual accounting system under which income is counted up at the end of each year. It would be disruptive of an orderly collection of the revenue to rule that the counting must be done over again to reflect events occurring after the year for which the count is made, and would violate the spirit of the annual accounting syestem. This basic principle cannot be changed simply because it is of advantage to a taxpayer or to the Government in a particular case that a different rule be followed.

The judgment of the Court of Appeals for the Second Circuit in No. 76, being consistent with this opinion, is affirmed, while the contrary judgment of the Court of Appeals for the Sixth Circuit in No. 138 is reversed. It is so ordered.

Judgment in No. 76 affirmed; judgment in No. 138 reversed.

Mr. Justice DOUGLAS dissents.

NOTE

1. *Other instances.* See also United States v. Lewis, supra page 103. In United States v. Lesoine, 203 F.2d 123 (9th Cir. 1953), it was held that stockholders were liable for a tax on dividends received in the year 1942, although they repaid the dividends to the corporation in the following year, upon discovery that surplus had been insufficient for the payment of dividends. Knight Newspapers, Inc. v. Commissioner, 143 F.2d 1007 (6th Cir. 1944), which was contrary, was not followed in the *Lesoine* case: it rested on the "constructive trust" theory rejected by the Supreme Court in the *Healy* case.

2. *Authority for deduction of "loss."* What is the statutory authorization for deducting the repayment as a "loss"? If reporting the salary in the year of the receipt had produced no tax (because the taxpayer had an oversupply of deductions), would he have had a loss in the year of repayment? See O'Meara v. Commissioner, 8 T.C. 622 (1947). See also Regs. §1.166-1(e), providing that claims (as for salary, rent, etc.) may be deducted as bad debts only if they have been "included in the return of income" for the taxable, or some previous, year. There is apparently no requirement that the inclusion in the return produce a tax.

3. *Effect of §1341.* As pointed out supra page 104, §1341 of the 1954 Code provides that if the deduction exceeds $3000, the tax benefit from the deduction shall not be less than the tax attributable to the item's inclusion in income in the earlier year. But there is no converse requirement that the value of the deduction may not *exceed* the tax cost of including the item. Perhaps the government will be less enthusiastic about the claim of right doctrine in the future.

FORT PITT BREWING CO. v. COMMISSIONER

210 F.2d 6 (3d. Cir. 1954), cert. denied, 347 U.S. 989

Before GOODRICH, STALEY and HASTIE, Circuit Judges.

By HASTIE, Circuit Judge:

We are asked to decide whether, in the particular circumstances of this case, [§446(b)] of the Internal Revenue Code justified the Commissioner of Internal Revenue in making "adjustments" of the Fort Pitt Brewing Company's gross income for 1942 and 1943, adding to income the amount of the net increase during each taxable year of the taxpayer's accounting "Reserve for Returnable Containers." . . .

Taxpayer, a Pennsylvania corporation, produces and sells large quantities of

malt and brewed beverages. It maintains its accounts on the accrual basis. It provides returnable containers — bottles, kegs and barrels — in which it packages and distributes its products. A regulation of the Pennsylvania Liquor Control Board requires a stipulated minimum deposit on all returnable original containers of gallon size or less in which brewed beverages are sold. All of the taxpayer's invoices contain the following stipulation:

Deposit for return of package is as follows: Barrels $8.00, Half Barrels $6.00, Quarter Barrels $4.00 and Eighth Barrels $1.00 each, Cartons of 2 Dozen Small Bottles 50¢, Case of 2 Dozen Small Bottles 75¢, Bottles short in cases returned will be charged at rate of 2¢ for small bottles. Purchaser buys only the beer delivered and billed. Bottles, Cases, Kegs, Etc. containing the products delivered therein are never sold but remain absolute property of Brewing Company. Deposit for return of packages repaid purchaser for number delivered only on return of packages to Brewing Company. Purchaser agrees to these conditions.

No time limit is specified for the return of containers. During 1942 taxpayer received deposits of almost $5,000,000 on containers. During 1943 the figure approached $6,000,000. Refunds in 1942 were nearly $100,000 less than deposits, and in 1943 over $200,000 less. A year by year picture of deposits, refunds and consequent bookkeeping accumulations is provided by the following table, with the taxable years italicized:

Fiscal Year Ended Oct. 31	Deposits Received	Deposits Refunded	Excess of Deposits Over Refunds	Balance in Reserve
1936 Balance				17,962.50
1937	842,464.25	832,179.75	10,284.50	28,247.00
1938	1,214,122.75	1,184,063.25	30,059.50	58,306.50
1939	2,381,485.50	2,335,750.65	45,734.85	104,041.35
1940	3,063,054.00	3,035,347.75	27,706.25	131,747.60
1941	3,998,938.27	3,910,821.23	88,117.04	219,864.64
1942	*4,822,919.50*	*4,739,947.90*	*82,971.60*	*302,836.24*
1943	*5,940,221.75*	*5,759,025.50*	*181,196.25*	*484,032.49*
1944	7,587,196.25	7,457,638.00	129,558.25	613,590.74
1945	7,500,625.50	7,400,878.25	99,747.25	713,337.99
1946	8,176,090.50	8,034,014.00	142,076.50	855,414.49
1947	9,824,681.00	9,601,216.32	223,464.68	1,078,879.17
1948	12,225,591.00	12,144,419.25	81,171.75	1,160,050.92
1949	12,260,618.50	12,364,799.00	(104,180.50)	1,055,870.42
1950	10,112,643.00	10,090,142.75	22,500.25	1,078,370.67
1951	8,401,717.25	8,455,950.25	(54,233.00)	1,024,137.67

The foregoing table is a summary of data carried in taxpayer's books as a "liability account" under the title "Reserve for Returnable Containers." At no time have any of these transactions or their economic consequences been permitted to enter into taxpayer's computation of its gross income. Yet, at no time did taxpayer in any way segregate money thus deposited from ordinary income or restrict its use in the ordinary course of its business.

In argument taxpayer has sought to picture this "Reserve" as something in the nature of a trust fund. But taxpayer itself never really regarded or dealt with these container deposits as a trust fund, or even as an actual reserve. As we already have said, taxpayer mingled such receipts with its general funds using them indiscriminately in its business. No reserve fund for repayment of deposits was set aside at the end of the year, or at any other time. A "Reserve" existed on paper in the taxpayer's books of account, but in no other way. For purposes of comparison it seems worth noting that even the conventional bank deposit creates only a simple

debt. Here the deposit for containers creates no more than a contractual obligation to repay the amount deposited, if and when the containers shall be returned.

But even though no trust is created, such a procedure of deposits and repayments is not designed for gain; yet, at times it may yield income. These characteristics are properly reflected in accounting and recognized in taxation. One familiar method of accounting for such transactions is based upon a conception of each cash deposit as security for the bailment of some article or articles, subject, however, to a mutual understanding that failure to return the property will result only in the discharge of the conditional obligation to repay the amount deposited. In this method of accounting, the distributed articles remain in the distributor's inventory, subject to depreciation, even though possession has been surrendered to someone else and return is uncertain. The amounts deposited are set up in a special account and regarded as wholly or partially offset by concomitant liability to make repayment. If this offset is only partial, the unobligated balance goes into current income. If the offset is total, no income is said to be realized at that time. It is at this point in accounting, the determination of the relationship between deposits and offsetting liability, that the difficulties in this case begin.

Where great numbers of articles are distributed in the course of trade to many persons, some will never be returned. Where the articles are destructible and in rather easily disposable containers it is obvious that a very considerable number will not be returned. It may be possible, largely on the basis of experience, to make a reasoned prediction of the percentage of the distributed articles which will not be returned. For this fraction of the deposits the theoretical offsetting repayment liability is not real. Accordingly, such offset will not be claimed when the fraction was determined in advance or at the end of each accounting period. Rather, the current account will show a minor fraction of the year's deposits with the offsetting liability, and this practically unobligated amount will be entered in the taxpayer's record of current income.

But in some situations it may not be feasible thus to approximate each year the percentage of current deposits which will never actually be required to meet repayment demands. So the taxpayer may elect to set up initially in its accounting for current deposits a theoretical 100 percent offsetting liability, with the result that there is no immediate determination of income, although in any given accounting period deposits may substantially exceed repayments. But if this is to be a bona fide and acceptable method of accounting it must be attended or followed by some fair and reasonably prompt determination or plan for determining at what time and in what amount any bookkeeping accumulation of actual deposits in excess of actual repayments shall be deemed to exceed future requirements for repayment and thus necessitate a transfer of the excess to surplus with attendant recognition of that sum as income.

The taxpayer here consistently from year to year maintained its accounts on the basis of a 100 percent offset of current deposits by a theoretical liability to make repayment for all containers. Yet, year by year its books revealed an increasing accumulation of an actual excess of deposits over repayments. This situation did not lead the taxpayer to adopt or propose any reasonable basis or time for a bookkeeping transfer of excess accumulations to an income category. Instead, taxpayer took and still defends the position that it may accumulate on its books indefinitely and without any restriction the excess of deposits over repayments. Thus an accounting procedure which, properly used, might legitimately have resulted in some postponement of accounting for sums as income until the amount thereof could be ascertained in fair approximation, has been misused to withhold the reporting of income indefinitely at the uncontrolled will and convenience of the taxpayer.

The impropriety of this procedure and the distorted picture of taxpayer's income it creates are the more glaring because of another accounting procedure which has been followed at the same time. We have already stated that all of taxpayer's containers, including those which were in the possession of the trade, were at all times carried in taxpayer's inventory. Moreover, each year in its accounting for income tax purposes taxpayer has claimed depreciation deductions on the cost of all of its containers at annual rates varying from 20 percent on bottles to 5 percent on barrels. This process necessarily results in a few years in an accounting recovery of substantially the entire cost of every container. The cost of containers, reserve for depreciation and undepreciated cost as shown in taxpayer's books are as follows:

Fiscal Year Ended October 31	Total Cost	Reserve for Depreciation	Undepreciated Cost
1936	$ 70,231.47	7,023.15	......
1937	100,928.47	9,260.66	91,667.81
1938	163,010.04	25,142.80	137,867.24
1939	258,362.95	51,334.14	207,028.81
1940	361,933.66	89,886.08	272,047.58
1941	481,391.01	144,891.32	336,499.69
1942	576,729.35	200,540.89	376,188.46
1943	666,368.03	254,981.61	411,386.36

It will be noted that in the taxable years alone the claimed container depreciation amounted to more than $100,000. Certainly, as the Tax Court found, some significant part of this annual depreciation must have represented loss and breakage of containers distributed to the trade. Yet, when it came to offsetting container deposits and preventing any part thereof from entering an income category, taxpayer claimed continuing full theoretical liability to pay for every container distributed since 1936. If a depreciation reserve for containers is maintained which recognizes and embraces some substantial loss and breakage of containers in the possession of the trade, certainly the so-called reserve for redemption of containers should be maintained, not at a theoretical maximum, but at a lesser figure similarly recognizing practical factors which reduce returns substantially below their theoretical maximum.

Here then is a clear and rather extreme case of accounting practice resulting in a substantial distortion of the picture of the taxpayer's income. The case plainly called for the exercise of the corrective function and powers of the Commissioner under the provisions of [§446(b)] and supplementary regulations. . . . It remains only to determine whether what the Commissioner did to correct this distorted picture was reasonable and proper.

We analyze and rationalize the Commissioner's action this way. It was clear to him that by 1942 a large part of the "reserve" in taxpayer's container deposit account was not supported by any real liability and, therefore, should be transferred to surplus and reported as income without further delay. The same was true of some fraction of the total additional deposits made in 1942 and 1943. In the Commissioner's view this aggregation of amounts to be added to income through 1943 equalled or exceeded the entire excess of current deposits over current repayments in 1942 and 1943 which the taxpayer sought to withhold from income and add to its container reserve. So the Commissioner telescoped corrective procedures by leaving the reserve as it stood at the end of 1941 and treating as taxable income the entire net increase of deposits in 1942 and 1943.

Perhaps these processes will be made clearer by actual calculation on an assumed, though not fanciful, basis. The Tax Court pointed out that from 1936 to

1951 it was the experience of the taxpayer that total repayments were 1.15 percent less than total deposits. On this theory, taxpayer itself suggests 1.15 percent of total pre-1942 deposits or a little more than $130,000 might be a proper transfer to surplus from pre-1942 accumulation. But this is only part of the picture. For, 1.15 percent of all deposits received in 1942 and 1943 must also be included to determine the total accumulation which on this theory would properly have been transferred to surplus and reported as income by the end of 1943. Thus augmented, the total of unreported income at the end of 1943 would be about $254,000 as compared with aggregate deficiencies of $264,000 actually assessed by the Commissioner for 1942 and 1943.

This $10,000 difference affords no substantial basis for complaint if we consider further that the use of 1.15 percent of total deposits to represent containers which never will be returned is rather favorable to the taxpayer. This is shown by the fact that at the end of 1943 more than 1½ percent of all containers distributed over the preceding years had not been returned.

The Tax Court said, in justification of the Commissioner's action,

> . . . it has not been shown that the amount added to income [i.e., the 1942 and 1943 excess deposits claimed as a "reserve"] will ever be required to discharge any . . . liability [for refunds].

In the light of the entire foregoing analysis we cannot characterize that conclusion as clearly wrong. If the Commissioner's determination was an imprecise approximation, the taxpayer who caused the difficulty by obviously improper accounting must at least show rather clearly that the Commissioner's result is unjust. This has not been shown here.

At the same time, it should be pointed out that the rather offhand device of simply requiring that any excess of deposits over refunds during the taxable year be reported as income cannot fairly be continued indefinitely, or very long, on no more showing than is in this record. Indeed, the point must be reached rather quickly where the bookkeeper reserve for past years is not unreasonably large, and thereafter a small percentage of deposits received during the taxable year itself will suffice without more to reflect the income derived during that year from dealings with containers. . . .

The judgment will be affirmed.

NOTE

1. *"Sale" of returnable containers.* If the taxpayer in the *Fort Pitt Brewing Co.* case had "sold" the containers to its customers (for the same amount as the "deposits") under an agreement to "repurchase" them at the customers' option, would the tax treatment be different? If so, how does one decide whether the amount collected from the customer is a "deposit" or a "purchase price"? Wichita Coca Cola Bottling Co. v. United States, 152 F.2d 6 (5th Cir. 1945), cert. denied, 327 U.S. 806 (1946); Nehi Beverage Co. v. Commissioner, 16 T.C. 1114 (1951); see also Rev. Rul. 60-243, 1960-2 C.B. 160 (Service will not consent to change from "deposit" to "sale and repurchase" method of accounting for returnable soft drink bottles because it does not "clearly reflect income"); Regs. §1.471-1.

If the taxpayer does not purport to sell the containers, and makes every effort to get its customers to return them, can the excess of deposits over the adjusted basis of the containers be treated as income arising on a "sale or exchange" of capital assets? As an "involuntary conversion" of property used in the trade or business and subject to depreciation within the meaning of §1231? See duPont & Co. v. United States, supra page 494.

2. *Other unclaimed items.* See also Boston Consolidated Gas Co. v. Commissioner, 128 F.2d 473 (1st Cir. 1942), holding that unclaimed customers' deposits were income to the taxpayer in the year it transferred a reserve for such deposits to surplus; Chicago, R.I., and P. Ry. Co. v. Commissioner, 47 F.2d 990 (7th Cir. 1931), holding similarly as to a

reserve for unclaimed overcharges. Why should such items be taxed as income in the year the taxpayer transfers the reserve to surplus? In the *Fort Pitt Brewing Co.* case, did the court include in income for 1942 and 1943 amounts that should have been included in earlier years? In Lehman v. Commissioner, ¶42,540 P-H Memo T.C., involving unclaimed dividends held by an investment banking firm for its customers, the Commissioner asserted that the amounts should be taxed as soon as the applicable statute of limitations barred an action by the customer against the taxpayer. While the court held that the running of the statute of limitations was not decisive, it upheld the Commissioner in taxing the items at that time in the absence of proof by the taxpayer that the statutory period was not a reasonable one for determining whether the amounts would be claimed by the customer. See also Policy Holders Agency, Inc. v. Commissioner, 41 T.C. No. 6 (1963) (unclaimed premium refunds held by accrual basis insurance agency for policy holders it could not locate held taxable income when credited to a "dividend stored account," not when this account was transferred, many years later, to surplus account).

How are excessive reserves for bad debts treated? Consider the possibility that a reserve for bad debts or for other contingencies may have to be taken into income when the taxpayer goes out of business or when a corporation liquidates. Rev. Rul. 57-482, 1957-2 C.B. 482; supra page 680.

DOBSON v. COMMISSIONER

320 U.S. 489 (1943), rehearing denied, 321 U.S. 231 (1944)

MR. JUSTICE JACKSON delivered the opinion of the Court.

These four cases were consolidated in the Court of Appeals. The facts of one will define the issue present in all.

The taxpayer, Collins, in 1929 purchased 300 shares of stock of the National City Bank of New York which carried certain beneficial interests in stock of the National City Company. The latter company was the seller and the transaction occurred in Minnesota. In 1930 Collins sold 100 shares, sustaining a deductible loss of $41,600.80, which was claimed on his return for that year and allowed. In 1931 he sold another 100 shares, sustaining a deductible loss of $28,163.78, which was claimed in his return and allowed. The remaining 100 shares he retained. He regarded the purchases and sales as closed and completed transactions.

In 1936 Collins learned that the stock had not been registered in compliance with the Minnesota Blue Sky Laws and learned of facts indicating that he had been induced to purchase by fraudulent representations. He filed suit against the seller alleging fraud and failure to register. He asked rescission of the entire transaction and offered to return the proceeds of the stock, or an equivalent number of shares plus such interest and dividends as he had received. In 1939 the suit was settled, on a basis which gave him a net recovery of $45,150.63, of which $23,296.45 was allocable to the stock sold in 1930 and $6,454.18 allocable to that sold in 1931. In his return for 1939 he did not report as income any part of the recovery. Throughout that year adjustment of his 1930 and 1931 tax liability was barred by the statute of limitations.

The Commissioner adjusted Collins' 1939 gross income by adding as ordinary gain the recovery attributable to the shares sold, but not that portion of it attributable to the shares unsold. The recovery upon the shares sold was not, however, sufficient to make good the taxpayer's original investment in them. And if the amounts recovered had been added to the proceeds received in 1930 and 1931 they would not have altered Collins' income tax liability for those years, for even if the entire deductions claimed on account of these losses had been disallowed, the returns would still have shown net losses.

Collins sought a redetermination by the Board of Tax Appeals, now the Tax Court. He contended that the recovery of 1939 was in the nature of a return of capital from which he realized no gain and no income either actually or con-

structively, and that he had received no tax benefit from the loss deductions. In the alternative he argued that if the recovery could be called income at all it was taxable as capital gain. The Commissioner insisted that the entire recovery was taxable as ordinary gain and that it was immaterial whether the taxpayer had obtained any tax benefits from the loss deduction reported in prior years. The Tax Court sustained the taxpayer's contention that he had realized no taxable gain from the recovery. . . .

The court below thought that the Tax Court's decision "evaded or ignored" the statute of limitation, the provision of the Regulations [§1.461-1(a)(3)] that "expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year," and the principle that recognition of a capital loss presupposes some event of "realization" which closes the transaction for good. We do not agree. The Tax Court has not attempted to revise liability for earlier years closed by the statute of limitation, nor used any expense, liability, or deficit of a prior year to reduce the income of a subsequent year. It went to prior years only to determine the nature of the recovery, whether return of capital or income. Nor has the Tax Court reopened any closed transaction; it was compelled to determine the very question whether such a recognition of loss had in fact taken place in the prior year as would necessitate calling the recovery in the taxable year income rather than return of capital. Section 272(g) [see 1954 Code, §6214(b)] provides that:

> the Board in redetermining a deficiency in respect of any taxable year shall consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency. . . .

The Tax Court's inquiry as to past years was authorized if "necessary correctly to redetermine" the deficiency. The Tax Court thought in this case that it was necessary; the Court of Appeals apparently thought it was not. This precipitates a question not raised by either counsel as to whether the court is empowered to revise the Tax Court's decision as "not in accordance with law" because of such a difference of opinion.

With the 1926 Revenue Act, Congress promulgated, and at all times since has maintained, a limitation on the power of courts to review Board of Tax Appeals (now the Tax Court) determinations. ". . . such courts shall have power to affirm or, if the decision of the Board is not in accordance with law, to modify or to reverse the decision of the Board . . ." [1954 Code, §7482(c)(1).] However, even a casual survey of decisions in tax cases, now over 5,000 in number, will demonstrate that courts including this Court have not paid the scrupulous deference to the tax laws' admonitions of finality which they have to similar provisions in statutes relating to other tribunals. After thirty years of income tax history the volume of tax litigation necessary merely for statutory interpretation would seem due to subside. That it shows no sign of diminution suggests that many decisions have no value as precedents because they determine only fact questions peculiar to particular cases. Of course frequent amendment of the statute causes continuing uncertainty and litigation, but all too often amendments are themselves made necessary by court decisions. Increase of potential tax litigation due to more taxpayers and higher rates lends new importance to observance of statutory limitations on review of tax decisions. No other branch of the law touches human activities at so many points. It can never be made simple, but we can try to avoid making it needlessly complex.

. . . Our modern income tax experience began with the Revenue Act of 1913. The World War soon brought high rates. The law was an innovation, its constitutional aspects were still being debated, interpretation was just beginning, and ad-

ministrators were inexperienced. The Act provided no administrative review of the Commissioner's determinations. It did not alter the procedure followed under the Civil War income tax by which an aggrieved taxpayer could pay under protest and then sue the Collector to test the correctness of the tax. The courts by force of this situation entertained all manner of tax questions, and precedents rapidly established a pattern of judicial thought and action whereby the assessments of income tax were reviewed without much restraint or limitation. Only after that practice became established did administrative review make its appearance in tax matters.

Administrative machinery to give consideration to the taxpayer's contentions existed in the Bureau of Internal Revenue from about 1918 but it was subordinate to the Commissioner. In 1923, the situation was brought to the attention of Congress by the Secretary of the Treasury, who proposed creation of a Board of Tax Appeals, within the Treasury Department, whose decision was to conclude Government and taxpayer on the question of assessment and leave the taxpayer to pay the tax and then test its validity by suit against the collector. Congress responded by creating the Board of Tax Appeals as "an independent agency in the executive branch of the Government." The Board was to give hearings and notice thereof and "make a report in writing of its findings of fact and decision in each case." But Congress dealt cautiously with finality for the Board's conclusions, going only so far as to provide that in later proceedings the findings should be "prima facie evidence of the facts therein stated." So the Board's decisions first came before the courts under a statute which left them free to go into both fact and law questions. Two years later Congress reviewed and commended the work of the new Board, increased salaries and lengthened the tenure of its members, provided for a direct appeal from the Board's decisions to the circuit courts of appeals or the Court of Appeals of the District of Columbia, and enacted the present provision limiting review to questions of law.

But this restriction upon judicial review of the Board's decisions came only after thirteen years of income tax experience had established a contrary habit. Precedents had accumulated in which courts had laid down many rules of taxation not based on statute but upon their ideas of right accounting or tax practice. It was difficult to shift to a new basis. This Court applied the limitation, but with less emphasis and less forceful resolution of borderline cases in favor of administrative finality than it has employed in reference to other administrative determinations.

That neglect of the congressional instruction is a fortuitous consequence of this evolution of the Tax Court rather than a deliberate or purposeful judicial policy is the more evident when we consider that every reason ever advanced in support of administrative finality applies to the Tax Court.

The court is independent, and its neutrality is not clouded by prosecuting duties. Its procedures assure fair hearings. Its deliberations are evidenced by careful opinions. All guides to judgment available to judges are habitually consulted and respected. It has established a tradition of freedom from bias and pressures. It deals with a subject that is highly specialized and so complex as to be the despair of judges. It is relatively better staffed for its task than is the judiciary. Its members not infrequently bring to their task long legislative or administrative experience in their subject. The volume of tax matters flowing through the Tax Court keeps its members abreast of changing statutes, regulations, and Bureau practices, informed as to the background of controversies and aware of the impact of their decisions on both Treasury and taxpayer. Individual cases are disposed of wholly on records publicly made, in adversary proceedings, and the court has no responsibility for previous handling. Tested by every theoretical and practical reason for administrative finality, no administrative decisions are entitled to higher

credit in the courts. Consideration of uniform and expeditious tax administrations require that they be given all credit to which they are entitled under the law.

Tax Court decisions are characterized by substantial uniformity. Appeals fan out into courts of appeal of ten circuits and the District of Columbia. This diversification of appellate authority inevitably produces conflict of decision, even if review is limited to questions of law. But conflicts are multiplied by treating as questions of law what really are disputes over proper accounting. The mere number of such questions and the mass of decisions they call forth become a menace to the certainty and good administration of the law.

To achieve uniformity by resolving such conflicts in the Supreme Court is at best slow, expensive, and unsatisfactory. Students of federal taxation agree that the tax system suffers from delay in getting the final word in judicial review, from retroactivity of the decision when it is obtained, and from the lack of a roundly tax-informed viewpoint of judges.

Perhaps the chief difficulty in consistent and uniform compliance with the congressional limitation upon the court review lies in the want of a certain standard for distinguishing "questions of law" from "questions of fact." This is the test Congress has directed, but its difficulties in practice are well known and have been subject of frequent comment. Its difficulty is reflected in our labeling some questions as "mixed questions of law and fact" and in a great number of opinions distinguishing "ultimate facts" from evidentiary facts.

It is difficult to lay down rules as to what should or should not be reviewed in tax cases except in terms so general that their effectiveness in a particular case will depend largely upon the attitude with which the case is approached. However, all that we have said of the finality of administrative determination in other fields is applicable to determinations of the Tax Court. Its decision, of course, must have "warrant in the record" and a reasonable basis in the law. But "the judicial function is exhausted when there is found to be a rational basis for the conclusions approved by the administrative body." Rochester Telephone Corp. v. United States, 307 U.S. 125, 146; . . .

The Government says that "the principal question in this case turns on the application of the settled principle that the single year is the unit of taxation." But the Tax Court was aware of this principle and in no way denied it. Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences. Where no statute or regulation controls, the Tax Court's selection of the course to follow is no more reviewable than any other question of fact. Of course we are not here considering the scope of review where constitutional questions are involved. The Tax Court analyzed the basis of the litigation which produced the recovery in this case and the obvious fact that "regarding the series of transactions as a whole, it is apparent that no gain was actually realized." It found that the taxpayer had realized no tax benefits from reporting the transaction in separate years. It said the question under these circumstances was whether the amount the taxpayer recovered in 1939 "constitutes taxable income, even though he realized no economic gain." It concluded that the item should be treated as a return of capital rather than as taxable income. There is no statute law to the contrary, and the administrative rulings in effect at the time tended to support the conclusion. It is true that the Board in a well considered opinion reviewed a number of court holdings, but it did so for the purpose of showing that they did not fetter its freedom to reach the decision it thought sound. With this we agree.

Viewing the problem from a different aspect, the Government urges in this Court that although the recovery is capital return, it is taxable in its entirety be-

cause taxpayer's basis for the property in question is zero. The argument relies upon [§1016(a)(1)], which provides for adjusting the basis of property for "expenditures, receipts, losses, or other items, properly chargeable to capital account." This provision, it is said, requires that the right to a deduction for a capital loss be treated as a return of capital. Consequently, by deducting in 1930 and 1931 the entire difference between the cost of his stock and the proceeds of the sales, taxpayer reduced his basis to zero. But the statute contains no such fixed rule as the Government would have us read into it. It does not specify the circumstances or manner in which adjustments of the basis are to be made, but merely provides that "Proper adjustment . . . shall in all cases be made" for the items named if "properly chargeable to capital account." What, in the circumstances of this case, was a proper adjustment of the basis was thus purely an accounting problem and therefore a question of fact for the Tax Court to determine. Evidently the Tax Court thought that the previous deductions were not altogether "properly chargeable to capital account" and that to treat them as an entire recoupment of the value of taxpayer's stock would not have been a "proper adjustment." We think there was substantial evidence to support such a conclusion.

The Government relies upon Burnet v. Sanford & Brooks Co., 282 U.S. 359, for the proposition that losses of one year may not offset receipts of another year. But the case suggested its own distinction: "While (the money received) equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses. . . . They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income." 282 U.S. at 363-64. It is also worth noting that the Court affirmed the Board's decision, which had been upset by the circuit court of appeals, and answered, in part, the contention of the circuit court that certain regulations were applicable by saying, ". . . nor on the record do any facts appear tending to support the burden, resting on the taxpayer, of establishing that the Commissioner erred in failing to apply them." 282 U.S. at 366-67.

It is argued on behalf of the Commissioner that the Court should overrule the Board by applying to this question rules of law laid down in decisions on the analogous problem raised by recovery of bad debts charged off without tax benefit in prior years. The court below accepted the argument. However, instead of affording a reason for overruling the Tax Court, the history of the bad debt recovery question illustrates the mischief of overruling the Tax Court in matters of tax accounting. Courts were persuaded to rule as matter of law that bad debt recoveries constitute taxable income, regardless of tax benefit from the charge-off. The Tax Court had first made a similar holding, but had come to hold to the contrary. Substitution of the court's rule for that of the Tax Court led to such hardships and inequities that the Treasury appealed to Congress to extend relief.[1]

[1] Mr. Randolph Paul, Tax Adviser to the Secretary of the Treasury, in a statement to the House Committee on Ways and Means said: "The Secretary has pointed out that wartime rates make it imperative to eliminate as far as possible existing inequities which distort the tax burden of certain taxpayers. I should like to discuss the inequities which the Secretary mentioned, as well as a few additional hardships. . . .

"(c) *Recoveries of bad debts and taxes.*—If a taxpayer who has taken a bad debt deduction later receives payment of such debt, such payment must be included in his income even though he obtained no tax benefit from the deduction in the prior year. While this result is theoretically proper under our annual system of taxation, it may produce severe hardships in certain cases through a distortion of the taxpayer's real income. At the same time, any departure from our annual system of taxation always produces administrative difficulties which serve to impede the collection of taxes.

"It is believed that the hardships can be removed and the administrative difficulties kept to a minimum by excluding from income amounts received in payment of the debt to the extent

It did so. [§111, relating to recoveries of bad debts, etc.] The Government now argues that by extending legislative relief in bad debt cases Congress recognized that in the absence of specific exemption recoveries are taxable as income. We do not find that significance in the amendment. A specific statutory exception was necessary in bad debt cases only because the courts reversed the Tax Court and established as matter of law a "theoretically proper" rule which distorted the taxpayer's income. Congress would hardly expect the courts to repeat the same error in another class of cases, as we would do were we to affirm in this case.[2]

The Government also suggests that "If the tax benefit rule were judicially adopted the question would then arise of how it should be determined," and the difficulties of determining tax benefits, it says, create "an objection in itself to an attempt to adopt such a rule by judicial action." We are not adopting any rule of tax benefits. We only hold that no statute or regulation having the force of one and no principle of law compels the Tax Court to find taxable income in a transaction where as matter of fact it found no economic gain and no use of the transaction to gain tax benefit. The error of the court below consisted of treating as a rule of law what we think is only a question of proper tax accounting.

There is some difference in the facts of these cases. In two of them the Tax Court sustained deficiencies because it found that the deductions in prior years had offset gross income for those years and therefore concluded that the recoveries must to that extent be treated as taxable gain. The taxpayers object that this conclusion disregards certain exemptions and credits which would have been available to offset the increased gross income in the prior years, so that the deductions resulted in no tax savings. In determining whether the recoveries were taxable gain, however, the Tax Court was free to decide for itself what significance it would attach to the previous reduction of taxable income as contrasted with reduction of tax. The statute gives no inkling as to the correctness or incorrectness of the Tax Court's view, and we can find no compelling reason to substitute our judgment. In No. 47 the decision of the Tax Court was upheld by the court below, and in that case the judgment is affirmed. In Nos. 44, 45, and 46, the Court of Appeals reversed the Tax Court, and for the reasons stated its judgments in those cases are reversed.

Reversed.

NOTE

1. *The "tax benefit" doctrine.* In addition to Perry v. United States, supra page 103, see the formulations of the tax benefit doctrine in Helvering v. State-Planters Bank & Trust Co., 130 F.2d 44, 46 (4th Cir. 1942):

> It is to be noted that only where the bad debt has been charged off and allowed as a deduction is it to be included in income when collected. The taxpayer is thus given an option by the statute and, only where he exercises the option, is he required to account for the collection as income. Where he does exercise it, however, by charging

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that the deduction on account of the debt in the prior year did not produce a tax benefit. The troublesome question whether a benefit resulted should be determined pursuant to regulations prescribed by the Commissioner with the approval of the Secretary. It is also suggested that this treatment be extended to refunds of taxes previously deducted." (Hearings before Committee on Ways and Means on Revenue Revision of 1942, 77th Cong., 2d Sess., Vol. I, 80, 87-88.)

[2] The question of whether a recovery is properly accounted for as income in the year received or should be related to a previous reported deduction without tax benefit is one with a long history and much conflict. It arises not only in case of recoveries of previously charged off bad debts and recoveries of the type we have here. It is also present in case of refund of taxes or cancellation of expenses or interest previously reported as accrued, adjustments of depreciation and depletion or amortization, and other similar situations.

off the debt as worthless in his return, he is bound by the election so made. . . . When he collects the debt thereafter he must account for the collection as income; for by electing to charge it off, he is precluded from treating it as capital or its collection as the restoration of capital and under the existing regulation impliedly consents that it be treated as income. When a debt has thus been charged off in one year and collected in a subsequent year, the fact that such charge off did or did not result in tax benefit, cannot be considered in connection with the taxability of its collection as income both because the taxability is determined by the charge off and not by the tax benefit accruing therefrom and because each taxable year must be regarded as an independent unit for income tax purposes.

See also Philadelphia National Bank v. Rothensies, 43 F. Supp. 923, 925 (E.D. Pa. 1942):

When a taxpayer claims and is allowed a bad debt against his taxable income there is no difficulty in finding an implied consent to be taxed in respect of future recovery of the bad debt, whether or not it is actually income. Whether this be called an implied agreement of waiver for valid consideration or an estoppel, is not of great importance.

If an item could have been, but was not, deducted with tax benefit, is a subsequent recovery taxable? In Ernsting's Estate v. Commissioner, ¶59,077 P-H Memo T.C., the court held that the taxpayer's basis for property that became worthless during the depression was zero, rather than its cost, even though he did not write it off on his tax return. Note the similarity between this result and the adjustment of the basis of depreciable property for "allowable" depreciation, whether deducted or not, under §1016(a)(2). Note also that excessive depreciation is not applied against the taxpayer's basis for the property if it produced no tax benefit (supra p. 457).

2. *What is the scope of "the" tax benefit doctrine?* Is the recovery taxable only to the extent of the tax actually saved in the earlier year, or is it taxable in full so long as the deduction was used in full, no matter how small the savings in tax? If the latter, is there any sound reason for requiring a tax benefit at all? Section 111, which covers many but not all of the tax benefit situations, allows the Commissioner to promulgate a method of applying the tax benefit doctrine to the recoveries that are within its scope. See Treas. Regs. §1.111-1, for some complexities that lurk in "the" tax benefit doctrine. In First National Bank v. Commissioner, 22 T.C. 209 (1954), it was held that the deduction of a bad debt produces tax benefit, so that a recovery may not be excluded under §111, if the deduction was *used* on the return to reduce taxable income, even though the taxpayer had other deductions or exemptions for the same year, not listed on the return, that could have been used instead. Eighteen months after the *Dobson* case was decided, the Treasury abandoned its view that the tax benefit doctrine was restricted to §111 items and amended the Regulations to embrace also "all other items subject to the rule of exclusion." The scope of the doctrine remains obscure.

Even if a deduction was of no tax benefit in the year it was taken, the taxpayer may have enjoyed a benefit in another year by reason of an operating loss or capital loss carryover. The broader the scope of these carryovers, and the longer the period to which they apply, the more frequently will a deduction produce tax benefit in some year.

3. *The Dobson case and judicial review of Tax Court decisions.* On the *Dobson* case's treatment of the proper scope of judicial review of the Tax Court, see Paul, Dobson v. Commissioner: The Strange Ways of Law and Fact, 57 Harv. L. Rev. 753 (1944). This doctrine led to an announcement by the Court of Appeals for the Second Circuit that it would affirm a Tax Court decision that would be reversed if made by a federal district court, Kirschenbaum v. Commissioner, 155 F.2d 23 (2d Cir. 1946). In 1948, Congress amended what is now §7482(a), to provide that Tax Court decisions shall be reviewed "in the same manner and to the same extent" as decisions of the federal district courts in civil cases tried without a jury. See Rice, Law, Fact, and Taxes: Review of Tax Court Decisions Under Section 1141 of the Internal Revenue Code, 51 Colum. L. Rev. 439 (1951). Even earlier, however, the Supreme Court's record on reviewing the Tax Court led Randolph Paul to remark: "For the time being the precise position of the Supreme Court on the *Dobson* issue cannot be determined by compass, the stars, or even the use of radar." Paul, The Place of the Courts in the Taxing Process, 39 Proc. of Nat. Tax Assoc. 462, 466 (1946).

4. *References.* Tye, The Tax Benefit Doctrine Re-examined, 3 Tax L. Rev. 329 (1948); Tye, Tax Benefit Developments, 2 id. 106 (1946); Plumb, The Tax Benefit Rule Today, 57 Harv. L. Rev. 129 (1943); Plumb, The Tax Benefit Rule Tomorrow, id. 675 (1944).

3. *The Correction of Errors*

BENNET v. HELVERING

137 F.2d 537 (2d Cir. 1943)

Before L. HAND, AUGUSTUS N. HAND, and FRANK, Circuit Judges.

L. HAND, Circuit Judge.

The taxpayers — husband and wife — appeal from a decision of the Tax Court refusing to allow them a deduction from their income tax for the year 1935, based upon the conceded fact that in that year fifty shares of stock of which the husband was the owner became worthless. The amount of the loss is not disputed, and the case may be simplified without prejudice to the Treasury by saying that it involves only a single question of law: May a taxpayer, who has received property, which was taxable as income when received,* but on which he has innocently failed ever to pay any tax, deduct its loss in a later year when it becomes worthless? The Commissioner argued, and the Tax Court held, that the privilege of making such a deduction was a correlative of the payment of a tax upon the income when originally received; and that, since the husband had failed to pay any tax upon the shares at any time, he could not deduct the loss in the year when they became worthless.

The situation must be distinguished from that of a claim for refund either by action of indebitatus assumpsit (Bull v. United States, 295 U.S. 247), or by claim for refund (R. H. Stearns Co. v. United States, 291 U.S. 54; Stone v. White, 301 U.S. 532). In both of these the taxpayer asks a return of money paid by him on the assumption that the Treasury unjustly retains it; and for that reason his claim has been held to be subject to a set-off to the extent that he has escaped payment of an earlier tax which would have been in fact due, if the earlier assessment had been properly computed, even though that involves in effect a reassessment.† In the case at bar the taxpayers ask no relief; it is the Commissioner who seeks to assess them, and in so doing to deny them a deduction whose propriety is undeniable on the facts: the shares were received as part of the taxpayer's income, they became worthless in 1935. Such a loss is concededly within the statute unless some reason, which it does not express, takes it out. That reason must be sufficient to overcome the bar of the statute against reassessment of an income tax more than three years after the return has been filed. §275(a) [now §6501(a)]. In several decisions we have held that the fact that the taxpayer has in the past omitted an item of charge from his gross income and has therefore never paid any tax upon it, does not toll the statute. Salvage v. Commissioner, 2 Cir., 76 F.2d 112, affirmed Helvering v. Salvage, 297 U.S. 106; Commissioner v. Union Pacific R. Co., 2 Cir., 86 F.2d 637; Schmidlapp v. Commissioner, 2 Cir., 96 F.2d 680, 683. Of course, if the omission has been consciously made, the return is fraudulent, and the tax may be assessed at any later time. [§6501(c).] We can see no reason why an innocent mistake should deprive the taxpayer of protection; statutes of limitation are passed precisely to put an end to the reconsideration of what has been once heard and decided; they presuppose that the original decision may have been erroneous.

* As compensation for services. — ED.

† This is the doctrine of recoupment, the present status of which is considered in the *Electric Storage Battery Co.* case, infra page 872, and in the note which follows it. — ED.

Some courts have reached the opposite result by holding the taxpayer to the truth of what he declared in his first return, when the second tax is assessed: this, on principles of estoppel. Crane v. Commissioner, 1 Cir., 68 F.2d 640; Commissioner v. Farren, 10 Cir., 82 F.2d 141; Alamo National Bank v. Commissioner, 5 Cir., 95 F.2d 622; Doneghy v. Alexander, 10 Cir., 118 F.2d 521. The basic difficulty with this is that, although adopted in the name of equity, it does not do equity unless supplemented by what in the end comes to a reassessment of the first tax. It by no means follows that to cancel a deduction in a later year will restore the situation to what it would have been, if the tax had been assessed correctly in the first year and the deduction allowed in the second; on the contrary, it seldom, if ever, will do so. It is only in case one supplements the doctrine by limiting it to those cases in which the taxpayer gained by the omission in the first year as much as, or more than, what he will lose by cancelling the deduction in the second, that it will work out equitably, and then only on the assumption that it is inequitable in the circumstances to allow the defense of the statute of limitations. The courts which have adopted this theory, have not shown any disposition to engraft such a condition upon it; and if they had, any logical force it might have had would have disappeared, for it would emerge for what it is, if it is to be an equitable doctrine at all: i.e. an excuse for reopening the earlier assessment in the face of the statute. Strictly, this point does not come up in the case at bar, not having been raised before the Tax Court, as the Commissioner concedes. Helvering v. Salvage, supra. Nevertheless, it fits so closely upon the theory on which he relies, that it has been necessary to consider it.

That theory is, not that the taxpayer was here "estopped" as to any fact by his earlier return, but that if the earlier assessment were made upon one theory of law, the same theory must be consistently followed thereafter: to be specific, that if the taxpayer's earlier tax was assessed on the assumption that the receipt of the shares was not income — even if the taxpayer had no part in inducing that error — justice demands that that assumption shall be carried over into any future year in which the shares again figure in the taxpayer's return. Some decisions have so held; it is a kind of estoppel as to the law. In Comar Oil Co. v. Helvering, 8 Cir., 107 F.2d 709, for example, the Treasury was allowed to cancel a deduction on the ground that it had been already once allowed and could not be allowed a second time, although there was no pretence of any estoppel as to the facts, for the Commissioner had acted with full knowledge of them. In Dixie Margarine Co. v. Commissioner, 6 Cir., 115 F.2d 445, and Gooch Milling & Elevator Co. v. Commissioner, 8 Cir., 133 F.2d 131, the courts applied the same doctrine conversely. The taxpayer was allowed to assert an outlawed refund to cancel a corresponding item in a deficiency assessed against it in a later year. On the other hand, we have already three times refused to accept such a doctrine (Bigelow v. Bowers, 68 F.2d 839; Lembcke v. Commissioner, 126 F.2d 940; Schmidlapp v. Commissioner, supra, 96 F.2d 680); and so has the First Circuit, twice (Commissioner v. Saltonstall, 124 F.2d 110; Countway v. Commissioner, 127 F.2d 69). With deference it seems to us, not only to have all the vices of an estoppel as to the facts, but not to have even the excuse which that doctrine has: i.e. that in making his return a taxpayer does represent that it contains his complete gross income; something which the Commissioner cannot know. Were an assessment a judgment, there might be some basis for an estoppel of record in both situations: the estoppel as to the law depending upon how far questions of law are regarded as subject to the doctrine of res judicata. But estoppels by judgment have nothing to do with the equity of the particular case, and indeed often operate very harshly; and none of the decisions on this subject have ever suggested that the Commissioner's assessment cre-

ates an estoppel by judgment. They have been uniformly based upon some supposed equity.

It may appear plausible that, if the Treasury is to be allowed to reopen a barred assessment in order to interpose a set-off to a claim for refund, it should be allowed to do the same thing in order to assess a tax. That privilege in cases of refund was based altogether upon the historical descent of the action of indebitatus assumpsit, and it may be thought that history should not remain an excuse for denying equity. But there lies behind that history in this instance something more real than accident. When a person seeks to recover money which he has paid, it does not offend our sense of fair play that before he is allowed to unravel what he has done, he should submit to the reopening of any past related transactions between him and the person against whom he is moving. But in assessing a tax, the Treasury is not on the defensive; it has the affirmative, it must bring the case within the statute which imposes the liability. If in order to do so, it must reopen a past transaction between the taxpayer and itself, which the law has declared definitively closed, its position is equitably much weaker than in the case of a refund. Such distinctions depend, not upon logic, but upon conventions which make up the greater part of what we consider just and unjust; they are not for that reason the less imperative, rather the contrary. In what we have said we do not rely upon [§6214(b)] or question the jurisdiction of the Tax Court.

Order reversed; deficiency expunged.

NOTE

1. *Other no-estoppel cases.* The position of the Court of Appeals for the Second Circuit was later endorsed by the First Circuit in the *Ross* case, supra page 784; see also Commissioner v. Mellon, 184 F.2d 157 (3d Cir. 1950); Fahs v. Florida Machine & Foundry Co., supra page 634; Alsop v. Commissioner, supra page 197 (reaffirming, in an omitted part of opinion, the *Bennett* case); Maguire and Zimet, Hobson's Choice and Similar Practices in Federal Taxation, 48 Harv. L. Rev. 1281 (1935).

In the section on stock dividends (supra p. 690), we saw that one of the purposes of §307(a) was to restore a measure of consistency to the tax treatment of sales of both original and dividend shares after the Regulations governing the allocation of basis, upon which both Commissioner and taxpayer had frequently relied, were invalidated by the *Koshland* and *Gowran* cases. One of the problems was that a taxpayer might have previously availed himself of the old regulation by allocating part of the basis of the original shares to dividend shares, computing gain accordingly on the sale of his dividend shares. With the invalidation of the Regulations, he would be able to claim his original basis on a sale of the original shares, and, under cases like Bennet v. Helvering, there would apparently be no estoppel. The rules of §307(a) require consistency of treatment in these circumstances.

2. *Other approaches.* As the court points out in *Ross,* taxpayers have sometimes been held to a duty of consistency by other courts. For example, in Wichita Coca Cola Bottling Co. v. United States, 152 F.2d 6 (5th Cir. 1945), cert. denied, 327 U.S. 806 (1946), the taxpayer claimed that amounts received from customers for containers represented the sales price of the articles rather than deposits. Consequently, the taxpayer argued, the amounts should have been reported as income in earlier years. In fact, the amounts had been excluded from income in the earlier years on the ground that they were deposits, and the government took the position that income was realized when the deposit account was later transferred to surplus. (See again the *Fort Pitt Brewing Co.* case, supra p. 857.) The court held that having represented the amounts as deposits, the taxpayer could not later assert that they were not:

> To raise this duty of consistency in tax accounting we do not think a willful misrepresentation need be proven, or all the elements of a technical estoppel. It arises rather from the duty of disclosure which the law puts on the taxpayer, along with the

> duty of handling his accounting so it will fairly subject his income to taxation. Having, though mistakenly, so represented a transaction as to defer taxation on it to a later year he ought not, when the time for taxation under his view of it comes, to be allowed to assert the tax ought to have been levied in the former year if it is then too late so to levy it. [152 F.2d at 8.]

This was a refund case, so perhaps the Court of Appeals for the Second Circuit would have arrived at the same result, but the Fifth Circuit treated the doctrine as one of general application. Indeed, the Second Circuit itself, only three years before it decided the *Bennet* case, held that income was realized on the collection of an account receivable because it had been charged off, though erroneously, in an earlier year. Kahn v. Commissioner, 108 F.2d 748 (2d Cir. 1940). See also Ben Bimberg & Co. v. Helvering, 126 F.2d 412 (2d Cir. 1942), where Judge L. Hand, discussing the power of the Commissioner to tax as income a refund of a tax that was erroneously deducted in an earlier year, said:

> The taxpayer continues to insist upon retaining the profit of the deduction so long as he does not consent to a reopening of the assessment; and patently he is not entitled to both deduction and exemption. Nor should he be permitted to reopen it if he would, because that would give him an option to throw the item in whichever year would profit him more. [126 F.2d at 413.]

See, however, Streckfus Steamers, Inc. v. Commissioner, 19 T.C. 1 (1952), where a taxpayer on the accrual basis deducted (erroneously, under the *Dixie Pine Products Co.* case, supra p. 843) a state sales tax, which it was contesting and did not pay. The Commissioner sought to tax as income the amount deducted when, in a later year, the taxpayer was held not liable for the sales tax. The Tax Court held for the taxpayer.

3. *Estoppel against the government.* The assertion of estoppel against the government occurs primarily when there has been reliance on official advice. For this problem, see pages 919-920 infra. See also Vestal v. Commissioner, 152 F.2d 132 (D.C. Cir. 1945).

ROTHENSIES v. ELECTRIC STORAGE BATTERY CO.

329 U.S. 296 (1946)

MR. JUSTICE JACKSON delivered the opinion of the Court.

This case represents an effort, thus far successful, to obtain advantage by way of recoupment of a claim for tax refund long since barred by the statute of limitations. The facts of this singular situation are not in dispute. From April 1919 to April 1926 the Electric Storage Battery Company paid excise taxes on the sale of storage batteries in the belief, shared by the Government, that such sales were subject to tax. In July of 1926 the company asserted otherwise and filed a refund claim. It asked refund only of that part of the taxes which it had paid between 1922 and 1926. Refund of the taxes paid earlier which the company now seeks to recoup were then barred by the statute of limitations and no claim ever has been filed for their refund and no action ever was begun for their recovery. Suit was brought, however, against the Collector for refund of the taxes paid after July 1922; judgment therefor was obtained in the district court, Electric Storage Battery Co. v. McCaughn, 52 F.2d 205; 54 F.2d 814, and affirmed by the Circuit Court of Appeals, 3 Cir., 63 F.2d 715. The Government finally settled by refund of $1,395,515.35, of which $825,151.52 represented tax and the balance interest.

During the years that the refunded excise tax was being collected, the taxpayer deducted it from income before calculation of its income tax, thereby deriving substantial benefits. The Commissioner, therefore, treated the refund as income for 1935, the year in which it was received, and because of it assessed additional income and excess profits taxes which with interest thereon totaled $229,805.34. The taxpayer paid the deficiency, filed claim for refund, and after it was rejected sued the Collector. It contended that the refund from the Government was not income to the taxpayer but that if it were so considered taxpayer should be per-

mitted, as against the additional tax caused by its inclusion, to recoup the amount of the barred excise taxes which it had paid between 1919 and 1922. Both courts below correctly held that the refund was properly assessed as income. . . . Both have held, however, that the income tax liability for 1935 should be extinguished by recoupment of the 1919 to 1922 excise taxes. The gravity of this holding to the administration of the tax laws led us to grant certiorari.

It is not contended that there is any statutory warrant for allowing barred tax refund claims by way of recoupment or otherwise.[1] Authority for it is said to be found in case law and taxpayer relies chiefly on two decisions of this Court, Bull v. United States, 295 U.S. 247, and Stone v. White, 301 U.S. 532. The essence of the doctrine of recoupment is stated in the *Bull* case; "Recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded." 295 U.S. 247, 262. It has never been thought to allow one transaction to be offset against another, but only to permit a transaction which is made subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.

The application of this general principle to concrete cases in both of the cited decisions is instructive as to the limited scope given to recoupment in tax litigation. In both cases a single transaction constituted the taxable event claimed upon and the one considered in recoupment. In both, the single transaction or taxable event had been subjected to two taxes on inconsistent legal theories, and what was mistakenly paid was recouped against what was correctly due. In Bull v. United States, the one taxable event was receipt by executors of a sum of money. An effort was made to tax it twice — once under the Income Tax Act as income to the estate after decedent's death and once under the Estate Tax Act as part of decedent's gross estate. This Court held that the amount of the tax collected on a wrong theory should be allowed in recoupment against an assessment under the correct theory.[2] In Stone v. White, likewise, both the claim and recoupment involved a single taxable event, which was receipt by an estate of income for a period. The trustees had paid the income tax on it but this Court held it was taxable to the beneficiary. Assessment against the beneficiary had meanwhile become barred. Then the trustees sued for a refund, which would inure to the beneficiary. The Court treated the transaction as a whole and allowed recoupment of the tax which the beneficiary should have paid against the tax the Government should not have collected from the trustees. Whatever may have been said indicating a broader scope to the doctrine of recoupment, these facts are the only ones in which it has been applied by this Court in tax cases.

The Government has argued that allowance of the claim of recoupment involved here would expand the holding in the *Bull* case. The Circuit Court of Appeals agreed that in the *Bull* case "The main claim and recoupment claim were more closely connected than they are here." Electric Storage Battery Co. v. Rothensies, 3 Cir., 152 F.2d 521, 524. But the court nevertheless allowed the claim be-

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[1] Indeed, the applicable provisions of the [1939] Revenue Code seem to direct a result opposite to that asked by respondent. Section 3774 provides that "A refund of any portion of an internal-revenue tax (or any interest, penalty, additional amount, or addition to such tax) made after the enactment of this Act, shall be considered erroneous — (a) if made after the expiration of the period of limitation for filing claim therefor, unless within such period claim was filed; . . ." Section 3775(b) provides, "A credit of an overpayment in respect of any tax shall be void if a refund of such overpayment would be considered erroneous under section 3774." And cf. McEachern v. Rose, 302 U.S. 56.

[See §6514(a) of the 1954 Code.]

[2] But the Court emphasized that refund of the incorrect tax was not barred by the statute at the time the Government proceeded for collection of the correct tax.

Some courts have reached the opposite result by holding the taxpayer to the truth of what he declared in his first return, when the second tax is assessed: this, on principles of estoppel. Crane v. Commissioner, 1 Cir., 68 F.2d 640; Commissioner v. Farren, 10 Cir., 82 F.2d 141; Alamo National Bank v. Commissioner, 5 Cir., 95 F.2d 622; Doneghy v. Alexander, 10 Cir., 118 F.2d 521. The basic difficulty with this is that, although adopted in the name of equity, it does not do equity unless supplemented by what in the end comes to a reassessment of the first tax. It by no means follows that to cancel a deduction in a later year will restore the situation to what it would have been, if the tax had been assessed correctly in the first year and the deduction allowed in the second; on the contrary, it seldom, if ever, will do so. It is only in case one supplements the doctrine by limiting it to those cases in which the taxpayer gained by the omission in the first year as much as, or more than, what he will lose by cancelling the deduction in the second, that it will work out equitably, and then only on the assumption that it is inequitable in the circumstances to allow the defense of the statute of limitations. The courts which have adopted this theory, have not shown any disposition to engraft such a condition upon it; and if they had, any logical force it might have had would have disappeared, for it would emerge for what it is, if it is to be an equitable doctrine at all: i.e. an excuse for reopening the earlier assessment in the face of the statute. Strictly, this point does not come up in the case at bar, not having been raised before the Tax Court, as the Commissioner concedes. Helvering v. Salvage, supra. Nevertheless, it fits so closely upon the theory on which he relies, that it has been necessary to consider it.

That theory is, not that the taxpayer was here "estopped" as to any fact by his earlier return, but that if the earlier assessment were made upon one theory of law, the same theory must be consistently followed thereafter: to be specific, that if the taxpayer's earlier tax was assessed on the assumption that the receipt of the shares was not income — even if the taxpayer had no part in inducing that error — justice demands that that assumption shall be carried over into any future year in which the shares again figure in the taxpayer's return. Some decisions have so held; it is a kind of estoppel as to the law. In Comar Oil Co. v. Helvering, 8 Cir., 107 F.2d 709, for example, the Treasury was allowed to cancel a deduction on the ground that it had been already once allowed and could not be allowed a second time, although there was no pretence of any estoppel as to the facts, for the Commissioner had acted with full knowledge of them. In Dixie Margarine Co. v. Commissioner, 6 Cir., 115 F.2d 445, and Gooch Milling & Elevator Co. v. Commissioner, 8 Cir., 133 F.2d 131, the courts applied the same doctrine conversely. The taxpayer was allowed to assert an outlawed refund to cancel a corresponding item in a deficiency assessed against it in a later year. On the other hand, we have already three times refused to accept such a doctrine (Bigelow v. Bowers, 68 F.2d 839; Lembcke v. Commissioner, 126 F.2d 940; Schmidlapp v. Commissioner, supra, 96 F.2d 680); and so has the First Circuit, twice (Commissioner v. Saltonstall, 124 F.2d 110; Countway v. Commissioner, 127 F.2d 69). With deference it seems to us, not only to have all the vices of an estoppel as to the facts, but not to have even the excuse which that doctrine has: i.e. that in making his return a taxpayer does represent that it contains his complete gross income; something which the Commissioner cannot know. Were an assessment a judgment, there might be some basis for an estoppel of record in both situations: the estoppel as to the law depending upon how far questions of law are regarded as subject to the doctrine of res judicata. But estoppels by judgment have nothing to do with the equity of the particular case, and indeed often operate very harshly; and none of the decisions on this subject have ever suggested that the Commissioner's assessment cre-

ates an estoppel by judgment. They have been uniformly based upon some supposed equity.

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Order reversed; deficiency expunged.

NOTE

1. *Other no-estoppel cases.* The position of the Court of Appeals for the Second Circuit was later endorsed by the First Circuit in the *Ross* case, supra page 784; see also Commissioner v. Mellon, 184 F.2d 157 (3d Cir. 1950); Fahs v. Florida Machine & Foundry Co., supra page 634; Alsop v. Commissioner, supra page 197 (reaffirming, in an omitted part of opinion, the *Bennett* case); Maguire and Zimet, Hobson's Choice and Similar Practices in Federal Taxation, 48 Harv. L. Rev. 1281 (1935).

In the section on stock dividends (supra p. 690), we saw that one of the purposes of §307(a) was to restore a measure of consistency to the tax treatment of sales of both original and dividend shares after the Regulations governing the allocation of basis, upon which both Commissioner and taxpayer had frequently relied, were invalidated by the *Koshland* and *Gowran* cases. One of the problems was that a taxpayer might have previously availed himself of the old regulation by allocating part of the basis of the original shares to dividend shares, computing gain accordingly on the sale of his dividend shares. With the invalidation of the Regulations, he would be able to claim his original basis on a sale of the original shares, and, under cases like Bennet v. Helvering, there would apparently be no estoppel. The rules of §307(a) require consistency of treatment in these circumstances.

2. *Other approaches.* As the court points out in *Ross,* taxpayers have sometimes been held to a duty of consistency by other courts. For example, in Wichita Coca Cola Bottling Co. v. United States, 152 F.2d 6 (5th Cir. 1945), cert. denied, 327 U.S. 806 (1946), the taxpayer claimed that amounts received from customers for containers represented the sales price of the articles rather than deposits. Consequently, the taxpayer argued, the amounts should have been reported as income in earlier years. In fact, the amounts had been excluded from income in the earlier years on the ground that they were deposits, and the government took the position that income was realized when the deposit account was later transferred to surplus. (See again the *Fort Pitt Brewing Co.* case, supra p. 857.) The court held that having represented the amounts as deposits, the taxpayer could not later assert that they were not:

> To raise this duty of consistency in tax accounting we do not think a willful misrepresentation need be proven, or all the elements of a technical estoppel. It arises rather from the duty of disclosure which the law puts on the taxpayer, along with the

> duty of handling his accounting so it will fairly subject his income to taxation. Having, though mistakenly, so represented a transaction as to defer taxation on it to a later year he ought not, when the time for taxation under his view of it comes, to be allowed to assert the tax ought to have been levied in the former year if it is then too late so to levy it. [152 F.2d at 8.]

This was a refund case, so perhaps the Court of Appeals for the Second Circuit would have arrived at the same result, but the Fifth Circuit treated the doctrine as one of general application. Indeed, the Second Circuit itself, only three years before it decided the *Bennet* case, held that income was realized on the collection of an account receivable because it had been charged off, though erroneously, in an earlier year. Kahn v. Commissioner, 108 F.2d 748 (2d Cir. 1940). See also Ben Bimberg & Co. v. Helvering, 126 F.2d 412 (2d Cir. 1942), where Judge L. Hand, discussing the power of the Commissioner to tax as income a refund of a tax that was erroneously deducted in an earlier year, said:

> The taxpayer continues to insist upon retaining the profit of the deduction so long as he does not consent to a reopening of the assessment; and patently he is not entitled to both deduction and exemption. Nor should he be permitted to reopen it if he would, because that would give him an option to throw the item in whichever year would profit him more. [126 F.2d at 413.]

See, however, Streckfus Steamers, Inc. v. Commissioner, 19 T.C. 1 (1952), where a taxpayer on the accrual basis deducted (erroneously, under the *Dixie Pine Products Co.* case, supra p. 843) a state sales tax, which it was contesting and did not pay. The Commissioner sought to tax as income the amount deducted when, in a later year, the taxpayer was held not liable for the sales tax. The Tax Court held for the taxpayer.

3. *Estoppel against the government.* The assertion of estoppel against the government occurs primarily when there has been reliance on official advice. For this problem, see pages 919-920 infra. See also Vestal v. Commissioner, 152 F.2d 132 (D.C. Cir. 1945).

ROTHENSIES v. ELECTRIC STORAGE BATTERY CO.

329 U.S. 296 (1946)

MR. JUSTICE JACKSON delivered the opinion of the Court.

This case represents an effort, thus far successful, to obtain advantage by way of recoupment of a claim for tax refund long since barred by the statute of limitations. The facts of this singular situation are not in dispute. From April 1919 to April 1926 the Electric Storage Battery Company paid excise taxes on the sale of storage batteries in the belief, shared by the Government, that such sales were subject to tax. In July of 1926 the company asserted otherwise and filed a refund claim. It asked refund only of that part of the taxes which it had paid between 1922 and 1926. Refund of the taxes paid earlier which the company now seeks to recoup were then barred by the statute of limitations and no claim ever has been filed for their refund and no action ever was begun for their recovery. Suit was brought, however, against the Collector for refund of the taxes paid after July 1922; judgment therefor was obtained in the district court, Electric Storage Battery Co. v. McCaughn, 52 F.2d 205; 54 F.2d 814, and affirmed by the Circuit Court of Appeals, 3 Cir., 63 F.2d 715. The Government finally settled by refund of $1,395,515.35, of which $825,151.52 represented tax and the balance interest.

During the years that the refunded excise tax was being collected, the taxpayer deducted it from income before calculation of its income tax, thereby deriving substantial benefits. The Commissioner, therefore, treated the refund as income for 1935, the year in which it was received, and because of it assessed additional income and excess profits taxes which with interest thereon totaled $229,805.34. The taxpayer paid the deficiency, filed claim for refund, and after it was rejected sued the Collector. It contended that the refund from the Government was not income to the taxpayer but that if it were so considered taxpayer should be per-

mitted, as against the additional tax caused by its inclusion, to recoup the amount of the barred excise taxes which it had paid between 1919 and 1922. Both courts below correctly held that the refund was properly assessed as income. . . . Both have held, however, that the income tax liability for 1935 should be extinguished by recoupment of the 1919 to 1922 excise taxes. The gravity of this holding to the administration of the tax laws led us to grant certiorari.

It is not contended that there is any statutory warrant for allowing barred tax refund claims by way of recoupment or otherwise.[1] Authority for it is said to be found in case law and taxpayer relies chiefly on two decisions of this Court, Bull v. United States, 295 U.S. 247, and Stone v. White, 301 U.S. 532. The essence of the doctrine of recoupment is stated in the *Bull* case; "Recoupment is in the nature of a defense arising out of some feature of the transaction upon which the plaintiff's action is grounded." 295 U.S. 247, 262. It has never been thought to allow one transaction to be offset against another, but only to permit a transaction which is made subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole.

The application of this general principle to concrete cases in both of the cited decisions is instructive as to the limited scope given to recoupment in tax litigation. In both cases a single transaction constituted the taxable event claimed upon and the one considered in recoupment. In both, the single transaction or taxable event had been subjected to two taxes on inconsistent legal theories, and what was mistakenly paid was recouped against what was correctly due. In Bull v. United States, the one taxable event was receipt by executors of a sum of money. An effort was made to tax it twice — once under the Income Tax Act as income to the estate after decedent's death and once under the Estate Tax Act as part of decedent's gross estate. This Court held that the amount of the tax collected on a wrong theory should be allowed in recoupment against an assessment under the correct theory.[2] In Stone v. White, likewise, both the claim and recoupment involved a single taxable event, which was receipt by an estate of income for a period. The trustees had paid the income tax on it but this Court held it was taxable to the beneficiary. Assessment against the beneficiary had meanwhile become barred. Then the trustees sued for a refund, which would inure to the beneficiary. The Court treated the transaction as a whole and allowed recoupment of the tax which the beneficiary should have paid against the tax the Government should not have collected from the trustees. Whatever may have been said indicating a broader scope to the doctrine of recoupment, these facts are the only ones in which it has been applied by this Court in tax cases.

The Government has argued that allowance of the claim of recoupment involved here would expand the holding in the *Bull* case. The Circuit Court of Appeals agreed that in the *Bull* case "The main claim and recoupment claim were more closely connected than they are here." Electric Storage Battery Co. v. Rothensies, 3 Cir., 152 F.2d 521, 524. But the court nevertheless allowed the claim be-

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1 Indeed, the applicable provisions of the [1939] Revenue Code seem to direct a result opposite to that asked by respondent. Section 3774 provides that "A refund of any portion of an internal-revenue tax (or any interest, penalty, additional amount, or addition to such tax) made after the enactment of this Act, shall be considered erroneous — (a) if made after the expiration of the period of limitation for filing claim therefor, unless within such period claim was filed; . . ." Section 3775(b) provides, "A credit of an overpayment in respect of any tax shall be void if a refund of such overpayment would be considered erroneous under section 3774." And cf. McEachern v. Rose, 302 U.S. 56.

[See §6514(a) of the 1954 Code.]

2 But the Court emphasized that refund of the incorrect tax was not barred by the statute at the time the Government proceeded for collection of the correct tax.

cause it considered that this Court had introduced the doctrine of recoupment into tax law and that it was "based on concepts of fairness." 152 F.2d 521, 524. It said it saw no reason for narrowly construing the requirement that both claims originate in the same transaction. We think this misapprehends the limitations on the doctrine of recoupment as applied to tax law and it leads us to state more fully reasons for declining to expand the doctrine beyond the facts of the cited cases.

It probably would be all but intolerable, at least Congress has regarded it as ill-advised, to have an income tax system under which there never would come a day of final settlement and which required both the taxpayer and the Government to stand ready forever and a day to produce vouchers, prove events, establish values and recall details of all that goes into an income tax contest. Hence a statute of limitation is an almost indispensable element of fairness as well as of practical administration of an income tax policy. . . .

As statutes of limitation are applied in the field of taxation, the taxpayer sometimes gets advantages and at other times the Government gets them. Both hardships to the taxpayers and losses to the revenues may be pointed out.[3] They tempt the equity-minded judge to seek for ways of relief in individual cases.

But if we should approve a doctrine of recoupment of the breadth here applied we would seriously undermine the statute of limitations in tax matters. In many, if not most, cases of asserted deficiency the items which occasion it relate to past years closed by statute, at least as closely as does the item involved here. Cf. Hall v. United States, 43 F. Supp. 130. The same is true of items which form the basis of refund claims. Every assessment of deficiency and each claim for refund would invite a search of the taxpayer's entire tax history for items to recoup. This case provides evidence of the extent to which this would go. When this suit was brought in 1943, the claim pleaded as a recoupment was for taxes collected over twenty years before and for over sixteen years barred by the statute. That claims dead so long can be resurrected under this doctrine, is enough to show its menace to the statute of limitations — at least as to those taxpayers whose affairs by accident or design take such shape that they can avail themselves of recoupment remedies. Moreover, we have held that the Tax Court has no jurisdiction to consider recoupment. Gooch Milling and Elevator Co. v. Commissioner, 320 U.S. 418. Hence, the availability of the remedy would depend on diverting the litigation to the district courts.

We cannot approve such encroachments on the policy of the statute out of consideration for a taxpayer who for many years failed to file or prosecute its refund claim. If there are to be exceptions to the statute of limitations, it is for Congress rather than for the Courts to create and limit them.

The judgment below is reversed.

MR. JUSTICE MURPHY is of the opinion, in which MR. JUSTICE BLACK and MR. JUSTICE RUTLEDGE join, that the judgment below should be affirmed. He believes that the claims for refund of the illegal assessments exacted from 1919 to 1922 arise out of the same subject matter as was involved in the Government's demand

3 In American Light & Traction Co. v. Harrison, 7 Cir., 142 F.2d 639, the court did not allow recoupment to the Government. But judiciously, it said, "Although here a hardship on the Government results from the taxpayer's inconsistency, the correlative provisions of this same statute will, in the converse of the instant situation, work an equal hardship on the taxpayer." 142 F.2d 639, 643. Whether or not Sections 3774 and 3775(b), supra, note 1, be taken to compel the conclusion we reach in this case, the court's recognition that both parties to taxation are affected impartially, though perhaps harshly, by policy of repose has application here. It may easily be overlooked, when the unfairness of the Government's retaining incorrectly collected monies of respondent is stressed, that the statute of limitations is primarily an instrument of fairness.

for additional taxes for 1935, thereby making applicable the rule of Bull v. United States, 295 U.S. 247.

NOTE

1. *Recoupment today.* As Mr. Justice Jackson points out, the Supreme Court held in the *Gooch Milling and Elevator Co.* case that the Tax Court has no jurisdiction to allow recoupment. The Court based its decision on what is now §6214(b):

> The Tax Court in redetermining a deficiency . . . for any taxable year . . . shall consider such facts with relation to the taxes for other years as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid. [320 U.S. 418, 420 (1943).]

Refund cases in the district courts and Court of Claims were distinguished because they are "tribunals possessing general equity jurisdiction." With the doctrine limited to these courts, it may be that judicial resistance to its application may increase in order to prevent "forum-shopping." In Ford v. United States, 276 F.2d 17 (Ct. Cl. 1960), the taxpayers were allowed to use a higher basis for inherited stock, in computing gain or loss on its sale, than was used by the estate in computing its federal estate tax liability. The court said that the case "comes fairly close to satisfying the recoupment standards of the Supreme Court," but that "the teaching of *Rothensies* is that [recoupment] is not a flexible doctrine, but a doctrine strictly limited, and limited for good reason." One judge dissented, arguing that recoupment should have been applied to offset the estate's tax savings (which inured to the benefit of the taxpayers) against the refund to which they were entitled in the income tax case. Another dissenting judge would have required the taxpayers to use the same date-of-death value that was used by the estate on grounds of estoppel; failing that, he would have applied the doctrine of recoupment. See also United States v. Bowcut, 287 F.2d 654 (9th Cir. 1961) (recoupment applied); and note the resemblance of the result in the *Perry* case, supra page 103, to the result achieved by the doctrine of recoupment.

2. *Statutory barriers to recoupment.* In McEachern v. Rose, 302 U.S. 56 (1937), the government was not allowed to set off a barred deficiency against a proper refund. Under §§6401(a) and 6402(a), if the taxpayer paid the barred deficiency, the payment would have to be refunded; and the crediting of a refund against a barred deficiency in such circumstances is forbidden by §6514(b). The Court decided that recoupment by the government was barred by these statutory provisions. (Query: why was recoupment allowed to the government in Stone v. White, summarized in the *Electric Storage Battery Co.* case?) As to recoupment by the taxpayer, it should be noted that §6514(a) forbids crediting an overpayment that cannot be refunded because of the statute of limitations against a deficiency for a year that is still open. See footnotes 1 and 3 in the *Electric Storage Battery Co.* case.

3. *Reference.* Note, Recoupment in Federal Taxation: When Does It Apply? 46 Va. L. Rev. 981 (1958).

CORY v. COMMISSIONER

261 F.2d 702 (2d Cir. 1958)

Before CLARK, Chief Judge, WATERMAN, Circuit Judge, and GALSTON, District Judge.

CLARK, Chief Judge.

On this review of a Tax Court decision finding a deficiency of $15,204.97 in their income tax for 1945, petitioners rely on the statute of limitations. Although the notice of deficiency was issued December 20, 1956 — more than ten years after the return was filed — the Tax Court found the assessment timely under I.R.C. 1954, §§1311-1314, which under stated conditions allow an additional one-year period for assessment of tax upon certain items of income. 29 T.C. 903. The petitioners now challenge this ruling.

In their 1944 return taxpayers had reported as long-term capital gains the receipt of $42,057.66 in royalty income from the autobiography, "Persons and Places" of the noted philosopher-poet George Santayana. All but $12,000 of these royalties, however, were held in escrow until the following year because of a dispute between taxpayers and a nephew of the author over title to the manuscript. Some years later, asserting that they received only $12,000 in 1944 and the remainder in 1945, petitioners claimed a tax refund. The Commissioner rejected their claim and also determined that the entire amount reported in the 1944 return was taxable as ordinary income, rather than long-term capital gain. In a decision finally entered on June 17, 1955, the Tax Court upheld the Commissioner's determination that the royalties were taxable as ordinary income, but ruled that petitioners received only $12,000 in 1944, as they contended. Petitioners sought review of this decision; but the Commissioner did not, and his time to do so expired on October 17, 1955. We affirmed the decision March 9, 1956, Cory v. C.I.R., 2 Cir., 230 F.2d 941, and certiorari was denied October 8, 1956, 352 U.S. 828. The Commissioner issued a notice of deficiency on December 20, 1956, for the $30,257.66 [1] royalties not reported for the year 1945.

Sections 1311-1314 of the Internal Revenue Code of 1954 follow the complicated form of expression which seems an occupational trait of revenue legislation. In summarized form they may be stated as allowing an additional year for assessment of a tax deficiency after a "determination" — defined in §1313(a)(1) as a decision of the Tax Court "which has become final" — correcting certain errors in tax returns. As applied to the present case the determination must be one which requires the exclusion from gross income of an item included in a return filed by the taxpayer which was erroneously excluded from the gross income of the taxpayer for another year. Further, there must be adopted in the determination a position maintained by the taxpayer which is inconsistent with the erroneous exclusion in question. The Tax Court has accepted the Commissioner's view that there was such a determination here which became final only on the denial of certiorari on October 8, 1956; and hence the notice of deficiency on December 20, 1956, was timely. The taxpayers deny that their position was ever "inconsistent," but say that in any event the court's determination as to them became final on October 17, 1955, when the Commissioner failed to file a cross-petition for review of the court's decision of June 17, 1955. Under this view the notice of deficiency would of course be too late.

Clearly these sections are applicable here. The Tax Court's determination that only $12,000 was received in 1944 excluded the remainder of the reported royalties from taxpayers' gross income for that year, and this sum should have been reported for the taxable year 1945. Moreover, the decision did adopt a position maintained by the taxpayer which was inconsistent with the erroneous omission of the royalties in 1945. It is true that petitioners' 1944 return disclosed in full all the relevant facts surrounding their receipt of the royalties. But the fact remains that in that return they took the position that the entire sum was received in 1944, whereas in the later claim for refund they urged that they did not obtain $30,257.66 of these royalties until 1945. This is sufficient to bring §§1311-1314 into play. Their language requires only inconsistency of position, not duplicity or deception by the taxpayer. For the sections operate equally against inconsistent positions of the Commissioner; their purpose is remedial, not punitive.

1 The $200 discrepancy in these figures seems to result from a payment of that amount for expenses of the publishers of "Persons and Places." The Tax Court included also a sum paid as escrow fee of $105.91. Taxpayers make no claim of error on these aspects of the determination.

On petitioners' further contention that §§1311-1314 do not cure the untimeliness of the Commissioner's assessment because the one-year period began to run on October 17, 1955, respondent must and does concede that the ruling that petitioners received only $12,000 in 1944 did become final on that date. For the Commissioner could not obtain review of that ruling unless he cross-petitioned for review. Helvering v. Pfeiffer, 302 U.S. 247, 250-251; Le Tulle v. Scofield, 308 U.S. 415, 421-422. Nevertheless, to break down a Tax Court decision for a single year into separate holdings and issues for decisional and assessment purposes would add to the confusion and complexity in operating under §§1311-1314. See Rosenthal v. C.I.R., 2 Cir., 205 F.2d 505, 512; Wilson v. C.I.R., 42 B.T.A. 1254. In this very case petitioners' construction of these sections would have compelled the Commissioner to institute a proceeding for the 1945 deficiency, while a modification of the Tax Court decision in the still pending prior action would have completely altered the parties' positions in the second proceeding. Accordingly, we hold that the real "determination" required by the statute was not had until judicial opinion was resolved into a final adjudication of the monetary assessments involved, and hence that the reassessment is timely under the statutes.

The final issue concerns the amount of additional income the Commissioner may attribute to 1945. The sections of the Code relevant here limit the reassessment to the increase or decrease in tax resulting "solely from the correct treatment of the item which was the subject of the error." §1314(a). This "item," petitioners contend, is not $30,257.66, the royalties petitioners mistakenly claimed they received in 1944, but at maximum half that sum, since on their 1944 return — because they treated the royalties as long-term capital gain — petitioners listed only half the amount of the royalties as gross income. In support of this position petitioners rely on numerous authorities interpreting [§6501(e)(1)(A)], a penalty section operable only in favor of the Government. Section [6501(e)(1)(A) extends] the statute of limitations where a taxpayer "omits from gross income an amount properly includible therein which is in excess of 25 per centum of the amount of gross income stated in the return." But §1312(3)(A) speaks only of "an item included in a return," not an amount includible in gross income. Accordingly, while the amount of error in the gross income which the taxpayers computed and reported in the 1944 return may be lower, the item included in that return which was the subject of the error is unquestionably the amount of royalties which they reported as received. Since they reported receipt of $42,363.57, even though they claimed that only half their gain was to be taken into account, the amount thus omitted from the 1945 return was $30,363.57, as the Tax Court has held.[2]

NOTE

1. *Scope of §§1311-1314.* Section 1312 sets out the "circumstances" in which an adjustment to the closed year is authorized. In *Cory*, the "circumstance" on which the government relied was that the determination for 1944 required the exclusion from gross income of an item included in a return filed by the taxpayer (for 1944) which was erroneously excluded or omitted from his return for the closed year (1945). See §1312(3)(A). Among the other "circumstances of adjustment" set out in §1312 are:

(a) A determination requiring the inclusion in gross income of an item that was erroneously included in the gross income of the taxpayer for another year. §1312(a)(1). If the court had gone the other way in *Amend*, supra page 780, this provision would have permitted the taxpayer to get a refund for the year in which the sales proceeds were reported by him, despite the running of the statute of limitations.

(b) A determination allowing a deduction that was erroneously allowed to the taxpayer for another year.

[2] Including the discrepancies referred to in note 1 supra.

(c) A determination of the basis of property, if certain types of errors occurred "in respect of any transaction on which such basis depends" with respect to the taxpayer or certain other persons. §1312(7). Consider the effect of this provision on the taxpayer in *Bennet,* supra page 869. If the 1924 transaction in Fahs v. Florida Machine & Foundry Co., supra page 634, had occurred in a year subject to adjustment under §1311,* would an adjustment be authorized as to Mr. Russell, Sr., by §1312(7)? If Mr. Russell's son sells his stock and claims a basis equal to its value when his father acquired it, would an adjustment against his father for the year of acquisition be authorized by §1312(7)?

2. *Maintenance of inconsistent position under §1311(b).* Ordinarily, an adjustment to a closed year is authorized only if the determination adopts a position maintained by the taxpayer (or the government, as the case may be) that is inconsistent with the error in the closed year. Note how this requirement was satisfied in the *Cory* case. If the taxpayer had reported the $42,000 in 1944 as ordinary income and had later claimed a refund *solely* on the ground that it was long-term capital gain, and a court had held that the royalties were taxable as ordinary income but that a refund was required because $30,000 was allocable to 1945, would the determination have "adopted . . . a position maintained by the taxpayer"? If in a bad debt case involving 1964 the government argues that the debt became worthless in 1963, and the court's findings consist solely of a statement that the debt did not become worthless in 1964, has the court "adopted . . . a position maintained by the taxpayer"? What if the court's opinion states that "there is persuasive evidence that the debt became worthless in 1963, but that is not before us"? If a court gives alternative grounds for a decision, has it "adopted" both of them? See Dobson v. United States, — F.2d — (Ct. Cl. 1964) (re "inconsistent" position); Yagoda v. Commissioner, — F.2d — (2d Cir. 1964).

If the adjustment is based on the errors described in §1312(3)(B) and §1312(4), inconsistency is not required, but another condition must be satisfied: roughly speaking, the closed year must have been open when the claim that resulted in the determination was first formally made. More specifically, if the determination requires the exclusion from gross income in 1965 of an item that was not included in the 1965 return, and the item should have been included in 1962, an adjustment for 1962 is authorized by §1312(3)(B) and §1311(b)(2) only if 1962 was an open year when the government first maintained by a notice of deficiency or before the Tax Court that the item was includible in 1965. Were it not for this requirement, the government could arbitrarily assign any omitted item to any open year, and then move for an adjustment to the closed year when the taxpayer succeeded in proving that the item did not belong in the year to which it was assigned. Conversely, if the determination disallows a deduction for 1965 which should have been allowed to the taxpayer in 1962, an adjustment is authorized by §1312(4) and §1311(b)(2)(B) only if 1962 was open when the taxpayer first maintained before the Treasury or Tax Court, in writing, that he was entitled to the deduction in 1965. Were it not for this requirement, a taxpayer who had overlooked a 1962 deduction could arbitrarily claim for the year in which he finally realized his error, and on losing in this claim, demand a refund for 1962. In effect, §1312(3)(B) and (4) simply preserves the status quo for 1962 while the 1965 battle is being fought, a result that could alternatively have been achieved by self-help at the outset through the filing of simultaneous refund claims (or the assertion of deficiencies, as the case may be) for both 1962 and 1965.

3. *Status of related taxpayers.* Note that a determination as to one taxpayer will often open the door to an adjustment under §1311 as to another taxpayer. A common example is the successful assertion of a deficiency against the grantor of a trust under §§671-677; if the same income was reported by the fiduciary or beneficiary, a refund is ordinarily authorized by §1312(1). The term "related taxpayer" is defined by §1313(c). Note that a corporation and its shareholders are not "related taxpayers," nor are corporations under common control; although there are many situations in which an item that was reported or deducted by one such person should have been reported or deducted by another, the correction of the error does not ordinarily open the door to a §1311 adjustment for the other taxpayer.

For an unsuccessful effort to require the husband of the taxpayer in Bradford v. Commissioner, supra page 89, to pay a tax for 1946 on the ground that the exclusion of the

* Sections 1311-1314 are not applicable to pre-1932 taxable years.

disputed $50,000 from the wife's return meant that it was properly includible in the husband's return, see Bradford v. Commissioner, 34 T.C. 1051 (1960).

4. *Extent of the adjustment.* When §1311 is applicable, an adjustment for the year of error is authorized by §1314 in the amount of "the increase or decrease in tax previously determined [for the year of error] which results *solely* from the correct" treatment of the item in question. I.e., the year of error is not reopened for the purpose of correcting unrelated errors, although items like the medical expense and charitable contribution deductions may have to be recalculated. The amount thus determined, with interest, is either refunded to the taxpayer or assessed and collected as a deficiency, as the case may be. As a result of a 1954 amendment, if the adjustment for the year of error creates, increases, or reduces an operating loss or capital loss for that year, other years to which the loss is carried over may also be adjusted.

Note that it may be better, for either the taxpayer or the government, to allow sleeping dogs to lie. In Gooch Milling and Elevator Co. v. United States, 78 F. Supp. 94 (Ct. Cl. 1948), for example, the taxpayer recovered $7935.58, with interest, under §1311 for the fiscal year ending June 30, 1935, because the government determined a deficiency of $6663.42 for the year ending June 30, 1936. If the deficiency had not been determined for 1936, the taxpayer could not have obtained a correction for 1935 because the statutory period for claiming a refund had expired. Conversely, the taxpayer who erroneously omitted property received as compensation from his income for the year of its receipt may be better off to employ a zero basis on a later sale of the property, since if he insists on its proper basis (thus reducing his capital gain in the year of sale), the government may be entitled under §1311 to recover a tax, with interest, on ordinary income for the earlier year.

5. *Relation of §1311 to estoppel and recoupment.* Note that estoppel, recoupment, and §1311 will never come into play unless a transaction or other event in one year is related to an error that occurred in another year. Many erroneous omissions, inclusions, and deductions will go entirely uncorrected, once the statute of limitations has run, because no later transaction will afford any basis for a claim of estoppel or recoupment or for an adjustment under §1311. Is there any reason why an erroneous deduction followed by a deduction of the same item in the proper year should be treated differently from an erroneous deduction standing alone? Or why an erroneous inclusion followed by a proper inclusion of the same item should lead to a correction that would not be permissible if the erroneous inclusion had no later counterpart?

As the court pointed out in the *Bennet* case, supra page 869, some courts apply the doctrine of estoppel to deny a loss on property erroneously omitted from income when received. But if the government can open the earlier year by way of an adjustment under §1311, is there any justification for estopping the taxpayer? Does the existence of §§1311-1314 imply that Congress has provided an exclusive remedy for the correction of errors committed in years closed by the statute of limitations? See Gooding v. United States, 326 F.2d 988 (Ct. Cl. 1964) (§§1311-1315 impliedly exclude recovery based on equitable recoupment).

6. *References.* Note, Sections 1311-15 of the Internal Revenue Code: Some Problems in Administration, 72 Harv. L. Rev. 1536 (1959); Burford, Basis of Property After Erroneous Treatment of a Prior Transaction, 12 Tax L. Rev. 365 (1957); Goetten, 3801 Brought up to Date; 13 N.Y.U. Inst. on Fed. Taxation 1119 (1955); Maguire, Surrey, and Traynor, Section 820 of the Revenue Act of 1938, 48 Yale L.J. 509, 719 (1939); Wilkinson, Mitigation of Effect of Statute of Limitations Under the Income Tax Laws, 27 Texas L. Rev. 818 (1949); Mullock, The Overlap of Section 481 and Sections 1311 to 1315, 39 Taxes 207 (1961).

For an exhaustive study of estoppel, recoupment, and §§1311-1314, see Mintz and Plumb, Taxing Income in Years Not Realized Under Doctrine of Equitable Estoppel, 1954 So. Calif. Tax Inst. 481.

UNITED STATES v. HOLLAND
348 U.S. 121 (1954)

MR. JUSTICE CLARK delivered the opinion of the Court.

Petitioners, husband and wife, stand convicted under [§7201] of an attempt to evade and defeat their income taxes for the year 1948. The prosecution was based on the net worth method of proof, also in issue in three companion cases and a number of other decisions here from the Courts of Appeals of nine circuits. During the past two decades this Court has been asked to review an increasing number of criminal cases in which proof of tax evasion rested on this theory. We have denied certiorari because the cases involved only questions of evidence and, in isolation, presented no important questions of law. In 1943 the Court did have occasion to pass upon an application of the net worth theory where the taxpayer had no records. United States v. Johnson, 319 U.S. 503.

In recent years, however, tax-evasion convictions obtained under the net worth theory have come here with increasing frequency and left impressions beyond those of the previously unrelated petitions. We concluded that the method involved something more than the ordinary use of circumstantial evidence in the usual criminal case. Its bearing, therefore, on the safeguards traditionally provided in the administration of criminal justice called for a consideration of the entire theory. At our last Term a number of cases arising from the Courts of Appeals brought to our attention the serious doubts of those courts regarding the implications of the net worth method. Accordingly, we granted certiorari in these four cases and have held others to await their decision.

In a typical net worth prosecution, the Government, having concluded that the taxpayer's records are inadequate as a basis for determining income tax liability, attempts to establish an "opening net worth" or total net value of the taxpayer's assets at the beginning of a given year. It then proves increases in the taxpayer's net worth for each succeeding year during the period under examination and calculates the difference between the adjusted net values of the taxpayer's assets at the beginning and end of each of the years involved. The taxpayer's nondeductible expenditures, including living expenses, are added to these increases, and if the resulting figure for any year is substantially greater than the taxable income reported by the taxpayer for that year, the Government claims the excess represents unreported taxable income. In addition, it asks the jury to infer willfulness from this understatement, when taken in connection with direct evidence of "conduct, the likely effect of which would be to mislead or to conceal." Spies v. United States, 317 U.S. 492, 499.

Before proceeding with a discussion of these cases, we believe it important to outline the general problems implicit in this type of litigation. In this consideration we assume, as we must in view of its widespread use, that the Government deems the net worth method useful in the enforcement of the criminal sanctions of our income tax laws. Nevertheless, careful study indicates that it is so fraught with danger for the innocent that the courts must closely scrutinize its use. . . .

1. Among the defenses often asserted is the taxpayer's claim that the net worth increase shown by the Government's statement is in reality not an increase at all because of the existence of substantial cash on hand at the starting point. This favorite defense asserts that the cache is made up of many years' savings which for various reasons were hidden and not expended until the prosecution period.

Obviously, the Government has great difficulty in refuting such a contention. However, taxpayers too encounter many obstacles in convincing the jury of the existence of such hoards. This is particularly so when the emergence of the hidden savings also uncovers a fraud on the taxpayer's creditors.

In this connection, the taxpayer frequently gives "leads" to the Government agents indicating the specific sources from which his cash on hand has come, such as prior earnings, stock transactions, real estate profits, inheritances, gifts, etc. Sometimes these "leads" point back to old transactions far removed from the prosecution period. Were the Government required to run down all such leads it would face grave investigative difficulties; still its failure to do so might jeopardize the position of the taxpayer.

2. As we have said, the method requires assumptions, among which is the equation of unexplained increases in net worth with unreported taxable income. Obviously such an assumption has many weaknesses. It may be that gifts, inheritances, loans and the like account for the newly acquired wealth. There is great danger that the jury may assume that once the Government has established the figures in its net worth computations, the crime of tax evasion automatically follows. The possibility of this increases where the jury, without guarding instructions, is allowed to take into the jury room the various charts summarizing the computations; bare figures have a way of acquiring an existence of their own, independent of the evidence which gave rise to them.

3. Although it may sound fair to say that the taxpayer can explain the "bulge" in his net worth, he may be entirely honest and yet unable to recount his financial history. In addition, such a rule would tend to shift the burden of proof. Were the taxpayer compelled to come forward with evidence, he might risk lending support to the Government's case by showing loose business methods or losing the jury through his apparent evasiveness. Of course, in other criminal prosecutions juries may disbelieve and convict the innocent. But the courts must minimize this danger.

4. When there are no books and records, willfulness may be inferred by the jury from that fact coupled with proof of an understatement of income. But when the Government uses the net worth method, and the books and records of the taxpayer appear correct on their face, an inference of willfulness from net worth increases alone might be unjustified, especially where the circumstances surrounding the deficiency are as consistent with innocent mistake as with willful violation. On the other hand, the very failure of the books to disclose a proved deficiency might indicate deliberate falsification.

5. In many cases of this type, the prosecution relies on the taxpayer's statements, made to revenue agents in the course of their investigation, to establish vital links in the Government's proof. But when a revenue agent confronts the taxpayer with an apparent deficiency, the latter may be more concerned with a quick settlement than an honest search for the truth. Moreover, the prosecution may pick and choose from the taxpayer's statement, relying on the favorable portion and throwing aside that which does not bolster its position. The problem of corroboration, dealt with in the companion cases of Smith v. United States, post, p. 147, and United States v. Calderon, post, p. 160, therefore becomes crucial.

6. The statute defines the offense here involved by individual years. While the Government may be able to prove with reasonable accuracy an increase in net worth over a period of years, it often has great difficulty in relating that income sufficiently to any specific prosecution year. While a steadily increasing net worth may justify an inference of additional earnings, unless that increase can be reasonably allocated to the appropriate tax year the taxpayer may be convicted on counts of which he is innocent.

While we cannot say that these pitfalls inherent in the net worth method foreclose its use, they do require the exercise of great care and restraint. . . . Trial courts should approach these cases in the full realization that the taxpayer may be ensnared in a system which, though difficult for the prosecution to utilize, is equally hard for the defendant to refute. Charges should be especially clear, including, in addition to the formal instructions, a summary of the nature of the net worth method, the assumptions on which it rests, and the inferences available both for and against the accused. Appellate courts should review the cases, bearing constantly in mind the difficulties that arise when circumstantial evidence as to guilt is the chief weapon of a method that is itself only an approximation. With these considerations as a guide, we turn to the facts.

The indictment returned against the Hollands embraced three counts. The first two charged Marion L. Holland, the husband, with attempted evasion of his income tax for the years 1946 and 1947. He was found not guilty by the jury on both of these counts. The third count charged Holland and his wife with attempted evasion in 1948 of the tax on $19,736.74 not reported by them in their joint return. The jury found both of them guilty. Mrs. Holland was fined $5,000, while her husband was sentenced to two years' imprisonment and fined $10,000.

The Government's opening net worth computation shows defendants with a net worth of $19,152.59 at the beginning of the indictment period. Shortly thereafter, defendants purchased a hotel, bar and restaurant, and began operating them as the Holland House. Within three years, during which they reported $31,265.92 in taxable income, their apparent net worth increased by $113,185.32. The Government's evidence indicated that, during 1948, the year for which defendants were convicted, their net worth increased by some $32,000, while the amount of taxable income reported by them totaled less than one-third that sum.

Use of Net Worth Method Where Books Are Apparently Adequate

As we have previously noted, this is not the first net worth case to reach this Court. In United States v. Johnson, supra, the Court affirmed a tax-evasion conviction on evidence showing that the taxpayer's expenditures had exceeded his "available declared resources." Since Johnson and his concealed establishments had destroyed the few records they had, the Government was forced to resort to the net worth method of proof. This Court approved on the ground that "to require more . . . would be tantamount to holding that skilful concealment is an invincible barrier to proof," 319 U.S., at 517-518. Petitioners ask that we restrict the *Johnson* case to situations where the taxpayer has kept no books. They claim that [§446(a) and (b)], expressly limiting the authority of the Government to deviate from the taxpayer's method of accounting, confines the net worth method to situations where the taxpayer has no books or where his books are inadequate. Despite some support for this view among the lower courts . . . , we conclude that this argument must fail. The provision that the "net income shall be computed . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer," refers to methods such as the cash receipts or the accrual method, which allocate income and expenses between years. United States v. American Can Co., 280 U.S. 412, 419. The net worth technique, as used in this case, is not a method of accounting different from the one employed by defendants. It is not a method of accounting at all, except insofar as it calls upon taxpayers to account for their unexplained income. Petitioners' accounting system was appropriate for their business purposes; and, admittedly, the Government did not detect any specific false entries therein. Nevertheless, if we believe the Government's evidence, as the jury did, we must

conclude that the defendants' books were more consistent than truthful, and that many items of income had disappeared before they had even reached the recording stage. . . . To protect the revenue from those who do not "render true accounts," the Government must be free to use all legal evidence available to it in determining whether the story told by the taxpayer's books accurately reflects his financial history.

Establishing a Definite Opening Net Worth

We agree with petitioners that an essential condition in cases of this type is the establishment, with reasonable certainty, of an opening net worth, to serve as a starting point from which to calculate future increases in the taxpayer's assets. The importance of accuracy in this figure is immediately apparent, as the correctness of the result depends entirely upon the inclusion in this sum of all assets on hand at the outset. The Government's net worth statement included as assets at the starting point . . . $2,153.09 in cash. The Hollands claim that the Government failed to include in its opening net worth figure an accumulation of $113,000 in currency . . . which they owned at the beginning of the prosecution period. They asserted that the cash had been accumulated prior to the opening date, $104,000 of it before 1933, and the balance between 1933 and 1945. The had kept the money, they claimed, mostly in $100 bills and at various times in a canvas bag, a suitcase, and a metal box. They had never dipped into it until 1946, when it became the source of the apparent increase in wealth which the Government later found in the form of a home, a ranch, a hotel and other properties. This was the main issue presented to the jury. The Government did not introduce any direct evidence to dispute this claim. Rather it relied on the inference that anyone who had had $104,000 in cash would not have undergone the hardship and privation endured by the Hollands all during the late 20's and throughout the 30's. During this period they lost their café business; accumulated $35,000 in debts which were never paid; lost their household furniture because of an unpaid balance of $92.20; suffered a default judgment for $506.66; and were forced to separate for some eight years because it was to their "economical advantage." During the latter part of this period, Mrs. Holland was obliged to support herself and their son by working at a motion picture house in Denver while her husband was in Wyoming. The evidence further indicated that improvements to the hotel, and other assets acquired during the prosecution years, were bought in installments and with bills of small denominations, as if out of earnings rather than from an accumulation of $100 bills. The Government also negatived the possibility of petitioners' accumulating such a sum by checking Mr. Holland's income tax returns as far back as 1913, showing that the income declared in previous years was insufficient to enable defendants to save any appreciable amount of money. The jury resolved this question of the existence of a cache of cash against the Hollands, and we believe the verdict was fully supported. . . .

The Government's Investigation of Leads

So overwhelming, indeed, was the Government's proof on the issue of cash on hand that the Government agents did not bother to check petitioners' story that some of the cash represented proceeds from the sales of two cafés in the 20's; and that in 1933 an additional portion of this $113,000 in currency was obtained by exchanging some $12,000 in gold at a named bank. While sound administration of the criminal law requires that the net worth approach — a powerful method of proving otherwise undetectable offenses — should not be denied the Government, its failure to investigate leads furnished by the taxpayer might result in serious injustice. It is, of course, not for us to prescribe investigative procedures, but it

is within the province of the courts to pass upon the sufficiency of the evidence to convict. When the Government rests its case solely on the approximations and circumstantial inferences of a net worth computation, the cogency of its proof depends upon its effective negation of reasonable explanations by the taxpayer inconsistent with guilt. Such refutation might fail when the Government does not track down relevant leads furnished by the taxpayer — leads reasonably susceptible of being checked, which, if true, would establish the taxpayer's innocence. When the Government fails to show an investigation into the validity of such leads, the trial judge may consider them as true and the Government's case insufficient to go to the jury. This should aid in forestalling unjust prosecutions, and have the practical advantage of eliminating the dilemma, especially serious in this type of case, of the accused's being forced by the risk of an adverse verdict to come forward to substantiate leads which he had previously furnished the Government. It is a procedure entirely consistent with the position long espoused by the Government, that its duty is not to convict but to see that justice is done.

In this case, the Government's detailed investigation was a complete answer to the petitioners' explanations. Admitting that in cases of this kind it "would be desirable to track to its conclusion every conceivable line of inquiry," the Government centered its inquiry on the explanations of the Hollands and entered upon a detailed investigation of their lives covering several states and over a score of years. The jury could have believed that Mr. Holland had received moneys from the sale of cafés in the twenties and that he had turned in gold in 1933 and still it could reasonably have concluded that the Hollands lacked the claimed cache of currency in 1946, the crucial year. Even if these leads were assumed to be true, the Government's evidence was sufficient to convict. The distant incidents relied on by petitioners were so remote in time and in their connection with subsequent events proved by the Government that, whatever petitioners' net worth in 1933, it appears by convincing evidence that on January 1, 1946, they had only such assets as the Government credited to them in its opening net worth statement.

Net Worth Increases Must be Attributable to Taxable Income

Also requisite to the use of the net worth method is evidence supporting the inference that the defendant's net worth increases are attributable to currently taxable income.

The Government introduced evidence tending to show that although the business of the hotel apparently increased during the years in question, the reported profits fell to approximately one-quarter of the amount declared by the previous management in a comparable period; that the cash register tapes, on which the books were based, were destroyed by the petitioners; and that the books did not reflect the receipt of money later withdrawn from the hotel's cash register for the personal living expenses of the petitioners and for payments made for restaurant supplies. The unrecorded items in this latter category totaled over $12,500 for 1948. Thus there was ample evidence that not all the income from the hotel had been included in its books and records. In fact, the net worth increase claimed by the Government for 1948 could have come entirely from the unreported income of the hotel and still the hotel's total earnings for the year would have been only 73% of the sum reported by the previous owner for the comparable period in 1945.

But petitioners claim the Government failed to adduce adequate proof because it did not negative all the possible nontaxable sources of the alleged net worth increases — gifts, loans, inheritances, etc. We cannot agree. The Government's proof, in our view, carried with it the negations the petitioners urge. Increases in

net worth, standing alone, cannot be assumed to be attributable to currently taxable income. But proof of a likely source, from which the jury could reasonably find that the net worth increases sprang, is sufficient. In the *Johnson* case, where there was no direct evidence of the source of the taxpayer's income, this Court's conclusion that the taxpayer "had large, unreported income was reinforced by proof . . . that [for certain years his] private expenditures . . . exceeded his available declared resources." This was sufficient to support "the finding that he had some unreported income which was properly attributable to his earnings. . . ." United States v. Johnson, 319 U.S., at 517. There the taxpayer was the owner of an undisclosed business capable of producing taxable income; here the disclosed business of the petitioners was proven to be capable of producing much more income than was reported and in a quantity sufficient to account for the net worth increases. Any other rule would burden the Government with investigating the many possible nontaxable sources of income, each of which is as unlikely as it is difficult to disprove. This is not to say that the Government may disregard explanations of the defendant reasonably susceptible of being checked. But where relevant leads are not forthcoming, the Government is not required to negate every possible source of nontaxable income, a matter peculiarly within the knowledge of the defendant. . . .

The Burden of Proof Remains on the Government

Nor does this rule shift the burden of proof. The Government must still prove every element of the offense beyond a reasonable doubt though not to a mathematical certainty. The settled standards of the criminal law are applicable to net worth cases just as to prosecutions for other crimes. Once the Government has established its case, the defendant remains quiet at his peril. . . . The practical disadvantages to the taxpayer are lessened by the pressures on the Government to check and negate relevant leads.

[Discussion of willfulness and of charge to jury omitted.]

NOTE

1. *The net worth method: accuracy and burden of proof. Holland* was a criminal prosecution. Is the net worth method of calculating taxable income "so fraught with danger for the innocent that the courts must closely scrutinize its use" in civil cases also? When the Commissioner imposes a fraud penalty or seeks to lift the statute of limitations because of fraud (infra p. 952), he has the burden of proof in cases in the Tax Court, §7454(a), and it has been held that this is true even in a suit in the District Court for a refund, Ohlinger v. United States, 219 F.2d 310 (9th Cir. 1955). In a simple deficiency case, however, is the taxpayer's usual burden of proof altered by the fact that the deficiency was computed by the net worth method? In *Holland,* the Court said that "an essential condition in cases of this type is the establishment, with reasonable certainty, of an opening net worth, to serve as a starting point from which to calculate future increases in the taxpayer's assets." If the taxpayer in a simple deficiency case calls as a witness the Treasury agent who made the reconstruction of taxable income and obtains an admission that the taxpayer was credited with an opening net worth of zero because the agent's investigations disclosed no opening assets, would the taxpayer's burden of proof be sustained if the agent's investigation was found to be superficial? See, for example, Bodoglau v. Commissioner, 230 F.2d 336 (7th Cir. 1956), concerning a professional gambler who was credited with only $15.03 of cash in the bank and no undeposited cash at the opening of the net worth period; the Tax Court said that the Commissioner's position was "logical" (because at various times the taxpayer was short of money in dealing with creditors) but "unrealistic," 22 T.C. 912, 928 (1954), and credited him with undeposited cash of $100,000, against his claim of over $200,000.

The net worth method is being used increasingly in small cases. See Hasson v. Com

missioner, 239 F.2d 778 (6th Cir. 1956), where the deficiencies (as adjusted by the Tax Court) were only $800 for 1948 and 1949 and $1000 for 1950. Judge Stewart dissented, expressing "serious doubts about the use at all of a method so inexact to arrive at amounts so relatively small as are involved here." 239 F.2d at 784. See Stuart v. Commissioner, ¶51,279 P-H Memo T.C., involving a dispute over $282 in tax, where the taxpayer's cost of living was in dispute and one of the issues was whether he spent $23 for newspapers or "generally was able to borrow rather than to buy the single newspaper he customarily read."

For other expressions of skepticism about the accuracy of the net worth method, see Thomas v. Commissioner, 266 F.2d 297 (6th Cir. 1959); Polizzi v. Commissioner, 265 F.2d 498 (6th Cir. 1959).

2. *"Likely source."* In requiring "evidence supporting the inference that the defendant's net worth increases are attributable to currently taxable income," does the Court in the *Holland* case mean that there must be proof of a "likely source"? In United States v. Ford, 237 F.2d 57 (2d Cir. 1956), the government argued that the taxpayer, a policeman who was a member of a vice squad, had a "likely source" in that gambling was rampant in his district and he had "opportunities" to receive bribes. The court held that proof of a "likely source" was not necessary because the government established "unreported current receipts from *some* source" and sufficiently negatived the possibility that they came from a non-taxable source because it "thoroughly investigated the defendant's affairs and financial condition and yet failed to uncover any substantial nontaxable receipts."

In United States v. Massei, 355 U.S. 595 (1958), the court said that proof of a "likely source" is not indispensable in a net worth case: "should all possible sources of nontaxable income be negatived, there would be no necessity for proof of a likely source." Short of an admission by the taxpayer, how can the government prove that his net worth increase is not attributable to non-taxable gifts and bequests?

3. *Undeposited cash on opening date.* The problem of the taxpayer's opening undeposited cash is most troublesome, as the Court indicates in the *Holland* case. Claims of vast wealth held in tin boxes are easily fabricated, and yet the newspapers frequently report such caches in the most unlikely places. The use of the taxpayer's prior economic circumstances to discredit such tales is often persuasive, but there are, after all, misers who hoard cash and live like beggars. The taxpayer's prior tax returns are often used, as in *Holland,* to prove that he could not have accumulated a large amount of cash, but the earlier returns — rather than the later ones — may have been false. See Kashat v. Commissioner, 229 F.2d 282 (6th Cir. 1956), concerning a taxpayer who claimed that his mother, who lived in a small village in Iraq, had accumulated over $40,000 in an earthen crock buried in the basement and that after her death he brought much of this with him to the United States in two suitcases. The Tax Court found the taxpayer's story "bizarre" and "fictional." (The government had introduced a "mathematical computation" to show that the claimed amount would have filled only one suitcase, rather than two, as the taxpayer stated; but the report does not show if the dollars used for the experimental computation was as wrinkled and bulky as the dollars which the taxpayer claimed to have obtained in Baghdad by changing Iraqui dinars for dollars.) The Court of Appeals concluded that fraud was not sufficiently established:

> A narrative which in the light of circumstances in other and more backward lands, standards of living and incentives to frugality, differing from our own, less confidence in banks, and more informal procedures in the passing of estates, is not to be transformed by mere fiat, because of its strangeness to an experienced and enlightened American mind, into the clear and convincing evidence, that is the inescapable imperative to a finding of fraud. [229 F.2d at 286.]

On the other hand, with respect to the deficiencies themselves, as distinguished from the fraud penalties, the Court of Appeals held that the Tax Court was justified in finding that the taxpayer had not met his burden of proof. See also, on the question of undeposited cash, Gunn v. Commissioner, 247 F.2d 359 (8th Cir. 1957).

In Goddard v. Commissioner, ¶62,083 P-H Memo T.C., the taxpayer (a government employee) claimed that while he was a student at the Yale Law School, he married a wealthy widow fifty years older than he for a cash payment of over $200,000, which was

kept in the form of undeposited cash for many years in order to preserve the secrecy of an arrangement of which he was ashamed. The court cited some evidence to support his claim and other evidence tending to discredit it, and finally accepted the story:

> The fact that a graduate of the Yale University Law School would be working for the Government in a minor clerical office at a little over $4,000 a year after 39 years of employment would of itself indicate that petitioner had serious personality deficiencies. In our opinion he was a thoroughly disagreeable man to deal with, was overly suspicious and secretive, and was impatient of all authority. He appeared to be still affected by shame over entering into the mercenary transaction connected with his first marriage. In our opinion he sought and found solace for this shame in the secret possession of large amounts of cash. We have concluded that he was an eccentric miser, whose course of conduct would not be that of normal men.

The taxpayer's miserly, secretive, and eccentric personality was evidently accepted not only as support for his claim of undeposited cash, but also as an explanation of a course of conduct during the tax investigation that might, as to normal persons, have been regarded as a badge of fraud.

4. *Living expenses in net worth cases.* Note that the taxpayer's non-deductible expenditures must be added to the increase in his net worth to compute taxable income. The government is able to prove the amount paid for federal income tax, if any; the taxpayer's checks (or his bank's microfilmed records) may aid in reconstructing his living expenses; and sometimes local stores and night clubs are circularized for additional information. See United States v. Costello, 221 F.2d 668 (2d Cir. 1955), where purchases of $60,000-90,000 per year were established by these methods. But in many cases, the government contents itself with an assumed cost of living of $600 per exemption, plus such amounts as may have turned up on an examination of bank records. See McCarthy v. Commissioner, ¶57,194 P-H Memo T.C., where the Tax Court made a downward adjustment in the taxpayer's own statement of his living expenses, on the ground that he (an Internal Revenue agent) had exaggerated his expenses to suppress the fact "that he was a 'cheapskate' and 'skinflint.'"

5. *Reconstructing the income of members of a closely knit family.* How is the net worth method to be applied if assets are commingled by members of a family and cannot be assigned with certainty to the earnings of any one person? In Lias v. Commissioner, 235 F.2d 879 (4th Cir. 1956), the court upheld a "consolidated family net worth" method by which the funds used to finance the family's investments and expenditures were assigned by the government to the taxpayer's wife, brother, mother-in-law, and brothers-in-law to the extent that they had reported income on their returns, the entire balance being assigned to the taxpayer. The taxpayer testified, and his testimony was not credited by the Tax Court. If he had introduced no defense whatsoever, would he be defeated by the presumption of correctness attaching to the Commissioner's action? What if a similar procedure of assigning income was used with respect to the other members of the family, so that the entire unreported income was taxed to each member in turn?

6. *Net worth increases and the taxpayer's accounting method.* In the *Holland* case, the Court says that the net worth method "is not a method of accounting at all, except insofar as it calls upon taxpayers to account for their unexplained income." Does the method assume that the taxpayer's increase in net worth and cash expenditures are to be treated as income in the year in which they occur? If so, how is the method to be applied to a taxpayer on the accrual basis?

7. *"Excess cash expenditure" and "bank deposit" methods of reconstructing income.* Another indirect method of computing taxable income is to analyze the taxpayer's cash expenditures and compare them with his "cash available." Assume, for example, that the taxpayer's records and tax returns report gross receipts of $100,000, and that by examining bank records, interviewing customers, etc., the Internal Revenue Service agent ascertains that $90,000 of this amount was received in checks and that $10,000 was received in cash. Assume further that the checks were deposited by the taxpayer, but not the cash, that he drew checks payable to cash in the amount of $10,000 against these deposits, and that the remaining $80,000 was either saved or paid by check to suppliers or others. So far, the taxpayer's "cash available" is $20,000. If it is now discovered that he spent $50,000 in

cash (including an assumed amount for living expenses not paid by checks), the agent reports $30,000 as "unexplained cash," and assumes that it represents unreported income unless the taxpayer had undeposited cash at the beginning of the period under examination, or had some other non-taxable sources of cash, such as loans, gifts, sales of property for cash, withdrawals from other accounts, etc. For examples of this method, see Marcella v. Commissioner, 222 F.2d 878 (8th Cir. 1955); Cohen v. Commissioner, 176 F.2d 394 (10th Cir. 1949); Caserta v. Commissioner, 199 F.2d 905 (3d Cir. 1952).

Still another method is the "bank deposit" method, which assumes that the taxpayer's bank deposits represent taxable income unless a non-taxable source is shown. See United States v. Doyle, 234 F.2d 788 (7th Cir. 1956); Doll v. Glenn, 231 F.2d 186 (6th Cir. 1956).

Both the "excess cash expenditure" method and the "bank deposit" method require a determination of undeposited cash at the opening of the period, as well as an exclusion of non-taxable receipts, and in these respects they resemble the net worth method.

8. *References.* Schmidt, Reconstruction of Income, 18 Tax L. Rev. 23 (1962); Avakian, Net Worth Computations as Proof of Tax Evasion, 10 Tax L. Rev. 431 (1955); Krasilovsky and Stein, An Evaluation of Net Worth Prosecution of Federal Income Tax Evaders, 7 Okla. L. Rev. 49 (1954); Morag, Some Economic Aspects of Two Administrative Methods of Estimating Taxable Income, 10 Nat. Tax J. 176 (1957).

BECHELLI v. HOFFERBERT

111 F. Supp. 631 (D. Md. 1953)

CHESTNUT, District Judge.

These two cases were tried together as they involved mainly similar questions. The plaintiffs in both suits are suing the Collector of Internal Revenue for alleged overpayment of personal income taxes for the years 1943, 1944 and 1945. After the plaintiffs had duly filed their income tax returns for the respective years the Commissioner of Internal Revenue in due course assessed deficiencies against each of the taxpayers for the respective years including a 5% penalty for alleged lack of due care in preserving bookkeeping records, and interest. . . .

The plaintiffs Bechelli and Giangrandi are naturalized citizens of former Italian nationality who have been engaged as partners in the business of conducting a comparatively small bar and restaurant in Baltimore City at or near 8 E. Preston Street, since 1934. . . . They were partners entitled to an equal division of the profits. The Commissioner determined that the partnership income had been understated for the three years in question respectively as follows:

For the year 1943	$5,130.02
For the year 1944	9,417.62
For the year 1945	764.37

Accordingly he determined deficiency assessments against Giangrandi and wife for understated income in the following amounts:

For the year 1943	$1,488.14
For the year 1944	920.31
For the year 1945	123.78

For Bechelli and wife the income deficiency was stated to be:

For the year 1943	$1,830.11
For the year 1944	1,868.67
For the year 1945	141.40

In all cases the Commissioner added a 5% penalty and interest. In considering the weight and effect of the evidence I accept the now well established rule in such cases that there is a presumption in favor of the correctness of the Commissioner's

determination and the burden of proof, by a preponderance of the evidence, is on the taxpayers to show the contrary.

The principal contention of counsel for the defendant Collector is that the bookkeeping records of the partnership were inadequate and insufficient to enable the Commissioner to determine the correct partnership income.

After hearing all the evidence in this case, including the testimony of Bechelli and Giangrandi and of their bookkeeper or accountant, and an examination of the exhibits in the case, including the partnership books, I conclude that the records of the partnership business as so kept were adequate as a matter of law and were reasonably and substantially correct in view of the nature of the business.

Bechelli and Giangrandi are not very literate or well educated persons but their bookkeeping was done for them by a Mr. Owens, a thoroughly credible witness, not an expert accountant but nevertheless familiar with proper bookkeeping methods from long experience as a clerk to the Deputy Comptroller of the B. and C. Railroad Company. He was a very long time and close friend of the partners and performed the service for them without pecuniary compensation, but was frequently at their place of business. The method of keeping the books was this. At the end of each day Giangrandi (or at times his chief employee in the business) prepared a written itemized statement showing the cash receipts of the day as taken from the tape on the cash register and an itemized statement of the expenses paid for the day for supplies for the bar or kitchen. This daily account of receipts and expenditures was given to Mr. Owens every two or three days and taken home by him and entered in the books for each day, at the end of the month for his own convenience. The daily sheets were not preserved but the receipts for the day and the expenses of the business, the latter separately classified, were recorded in permanent books which were offered in evidence. These books show that such an entry was made for each day of the month. Originally the daily receipts from the bar and from the kitchen were not separated but during the war years, when food rationing was in force, the bar receipts were entered separately from the kitchen receipts. The expenses were classified and separately entered for each day under different headings such as

bar expense, kitchen expense, salaries, miscellaneous supplies, laundry, rent, electricity and telephone, advertising and donations, fixtures and repairs, taxes, license fees, watchman service, miscellaneous.

The testimony of the witnesses satisfied me that the bookkeeping was honestly and fairly done and that the figures entered in the books for gross income and expenses were substantially correct. The critical test as to the sufficiency of the books on their face is whether they are sufficient to calculate the net income. If they are sufficient in this respect then the simpler the books the better. There is no prescribed detail as to just what books or how many must be kept. The question in each case must be determined on its particular facts and in view of the nature, volume and complexity of the business. Here the books as kept do show day by day receipts and expenses. If the figures are correct the books are sufficient to show the net income. Of course the books on their face are not conclusive of the proper figures and their inaccuracy, whether by inadvertence or fraud, can be shown by other evidence. In this case there is no such other evidence; nor is there any evidence even of reasonable suspicion as to the fairness and accuracy of the books as kept. It appears from the evidence of the Internal Revenue Agent who was instructed to examine the books and prepare his report to the Commissioner, that the particular investigation was based primarily on an anonymous letter suggesting that one of the partners, Giangrandi, had recently been buying a sub-

stantial amount of government bonds. When this was suggested to Giangrandi he at once without hesitation and with entire voluntary cooperation with the agent took him to his safe deposit box and showed all the investments that he had which the agent was frankly candid in saying were purchases well within the taxpayer's income. Nor is there any evidence of any other increase in net worth of either of the taxpayers. Both are men of comparatively modest property holdings consisting principally, as to Bechelli, of the ownership of the building in which the restaurant is conducted on the lower floors and, as to Giangrandi, his principal holdings consist of his dwelling and a few thousand dollars of bonds or stock accumulated by the partners respectively during their nearly twenty years of business activity. Nor is there any evidence tending to show large or unusual expenditures on their part. Still further their testimony as witnesses subject to examination and cross-examination very affirmatively tends to indicate that their business and their business records were honestly conducted and kept. They both seemed to me to be entirely credible witnesses.

The chief contention of government counsel as to the alleged inadequacy of the records is that the partnership did not preserve the daily cash register receipts or table checks to support the figures in the books after the entries had been made in the permanent book. Thus it is said that the books consisted only of a cash book and invoices. But in addition thereto the partnership did keep a bank account which was made available to and examined by the revenue agent. No criticism is based on it nor on the sufficiency or accuracy of the invoices for goods purchased. As the larger part of the purchases for the business consisted of whiskey, wine and beer for the bar there were, by virtue of various governmental regulations, records of all such purchases and there is no criticism of the accuracy or completeness of the invoices or expenditures for food and liquor. . . .

The only item which [the agent] undertook to revise was the receipts from the bar. These consisted of the sales of whiskey, wine and beer. The receipts from these three sources or bar revenues were not segregated in the books and I know of no requirement that they should have been. It was the theory of the Agent that the partnership must have made larger profits on the sale of whiskey than the books apparently indicated from the bar receipts. What the agent undertook to do, therefore, was to determine what percentage of the total bar receipts was attributable to the sale of whiskey. It is not contended that this percentage could be determined with real accuracy but the Agent estimated that 64.3% of the bar receipts were for whiskey. He reached this percentage by a comparison of the purchase invoices for all liquor in 1944 which he said showed that 64.3% of all liquor purchased was whiskey. He then assumed without further computation that the same percentage of whiskey was purchased for the bar in 1943 and 1945. And he further assumed that the percentage of whiskey sold at the bar should be the same as the percentage of all liquors bought for the bar in the one year. Having thus estimated the percentages of whiskey, wine and beer sold, he made a further division between whiskey sold in the package (by the bottle or case) and the amount of whiskey sold at the bar by the glass or drink. His computation then proceeded to estimate the gross profit that *should* have been received from the individual sales of the several classes of liquor by applying to each sale a so-called "mark-up" of sale price over cost price. For this mark-up price he assumed, based on information received from a circular issued by Seagram Distillers, that bar whiskey, that is whiskey sold by the drink served over the bar to an individual customer, should be marked up 144%. He further assumed the bottled whiskey should be marked up 26% and that beer should be marked up 100%, while wine and food should not be marked up over cost price at all.

Counsel for the plaintiffs dispute the propriety of the mark-up practice both

as to the amount and as to principle. I am satisfied, however, that where the taxpayer engaged in merchandising does not keep books which if true show the receipts from sales, there is good judicial authority to apply a proper percentage of mark-up for sale price over cost price. The percentage, of course, will vary with the particular business. Gamm v. Commissioner, 5 Cir., 39 F.2d 73; Harvey v. Early, 4 Cir., 189 F.2d 169; and numerous other cases in the Tax Court. But while the use of mark-up is correct in principle in particular cases, I am satisfied that the evidence in this case makes it inapplicable both in principle and in fact, and the figures that are ultimately obtained thereby are based on analyses and assumptions which are contrary to the actualities of the case as disclosed by the evidence. In the first place, it is not at all clear to me that the Agent's percentage figure of 64.3% for whiskey sold is a reliable figure even as a reasonably approximate estimate. Again it seems to have been the assumption that all the whiskey used at or in connection with the bar was paid for at certain minimum prices of not less than 35¢ per drink of a certain quantity. The evidence as to the activities of the business show that the Agent's estimates as to price and quantity were less than he figured. For instance, the evidence of the bartender was that many drinks were sold for 25¢ and not for 35¢ per established quantity and that for much of the time the quantity per drink was more than that estimated by the agent. Again the Agent assumed that beer was sold at 20¢ per glass while the testimony shows that it was sold at 15¢ per glass. Still further evidence was that during the war years the quality of employees for service was poor and there was much incidental loss in spillage, breakage and pilferage. It thus seems clear enough that the basis for revision of the partnership income as made by the Commissioner in this case is far more complex than the simple application of a mark-up of sale price over cost price to determine receipts where quantities of the goods sold are known but the books do not correctly show the actual receipts. In the instant case the revision made is more highly complex in that to determine the quantity sold requires a very detailed analysis of figures based on various assumptions and resulting in estimates only and is applied not to actual known gross quantities sold but only to one kind of one class of liquors sold. Counsel have not referred me to any case which seemingly justifies a revision of this complex character.

I conclude, therefore, both on the law and the facts that the partnership returns were adequate, sufficient and accurate. . . .

The Commissioner imposed a 5% penalty [§6653(a)] for the taxpayers' carelessness in bookkeeping records. It will be noted that this was not a fraud penalty and the government has not charged fraud at all in this case. Counsel for the government states that the 5% penalty was imposed for the failure to preserve inventories in sufficient detail and also because there were no capital or income accounts between the partners themselves. It is not contended that in fact either partner overdrew his half share of the profits. The failure to preserve supporting data such as table checks or particular bar receipts, if any were given, was naturally a matter of dissatisfaction to an expert accountant and it is obvious that if more care had been taken in this respect very probably these suits would have been avoided. I do not think the Commissioner acted arbitrarily or capriciously in imposing the 5% penalty for the reason stated. I have concluded that his action in this respect should not be disturbed. . . .

NOTE

Percentage mark-up and other ratio methods of reconstructing income. Despite its fate in this case, the percentage mark-up method is often used to compute taxable income. See Kurnick v. Commissioner, 232 F.2d 678 (6th Cir. 1956) (liquor store). For

other cases in which the Commissioner recomputed income on the theory that the taxpayer did as well as the average in his occupation or industry, see Roberts v. Commissioner, 176 F.2d 221 (9th Cir. 1949) (taxi driver's tips equal to 10 per cent of gross receipts); Cesanelli v. Commissioner, 8 T.C. 770 (1947) (waiter's tips equal 10 per cent of customers' bills; court rejected taxpayer claim that only 8 out of 10 customers tip, that customers do not tip on liquor, and that 5 per cent was average tip); Delsanter v. Commissioner, 28 T.C. 845 (1957) (gambling casino: average profit on off-track betting, 12 per cent of amount bet; average profit at dice table, 10 times salaries of staff manning the table, etc.).

See also D & H Bagel Bakery, Inc. v. Commissioner, ¶55,100 P-H Memo T.C. (retail bakery income reconstructed by applying average price per dozen bagels to number manufactured, computed by formula based on amount of flour purchased, with allowance for shrinkage from waste, personal consumption by employees, returns of stale merchandise, etc.); Jackson v. Commissioner, ¶53,240 P-H Memo T.C. (tax consultant's income reconstructed by applying average fee per return to total number of returns prepared by him); Cipollone's Sales & Service, Inc. v. Commissioner, ¶56,080 P-H Memo T.C. (income of used car dealer who sold for cash above invoice price reconstructed by ascertaining average amount of cash paid by some purchasers, and assuming this amount was received on every sale); Agnellino v. Commissioner, 302 F.2d 797 (3d Cir. 1962) (income of motel estimated by multiplying number of bed sheets rented from commerical laundry by average charge per room, on assumption that two sheets were used by each guest per night); MacCrowe's Estate v. Commissioner, 264 F.2d 621 (4th Cir. 1959) (reconstruction of abortionist's income by estimating number of abortions performed from number of morphine tablets purchased and multiplying by estimated average fee per case; held, "morphine method" too unreliable to serve as sole basis of decision).

CHAPTER 10

Tax Practice and Procedure

Section A. Procedure in the Internal Revenue Service *

1. *Deficiency Cases*

Selection of tax returns for examination. During the fiscal year 1963, the Internal Revenue Service received 66.5 million income tax returns, 6.1 million declarations of estimated tax, and 327 million information returns. The first administrative step with respect to the 66.5 million tax returns was mathematical verification; of 57.5 million individual returns which were verified, 2.4 million contained errors. About two thirds of these under-calculated the tax liability by a total of about $150 million; the other one third overstated the tax by about $70 million. Following this superficial examination by the Collection Division, the returns go to the Audit Division of the District Director's office, where they are classified: some are accepted as filed; others are assigned to examiners for office audit (the taxpayer being asked to bring or mail pertinent records to the internal revenue office) or for field audit (the examiner going to the taxpayer's office or home for a more detailed examination of his books and records).

The selection of returns for audit is obviously a critical point in the revenue process: although a return that is accepted as filed is not immune from re-examination until the period of limitations has run, it will almost certainly not be pulled out of its resting place unless the examination of a subsequent return or some other such development suggests such action.

The Service, not surprisingly, does not announce publicly all the criteria determining whether returns will be subjected to audit or not. Returns reporting income above certain levels, altered from time to time in accordance with the agency's workload, are automatically assigned for audit. The returns of gamblers are apparently also "automatics," and it is said that the returns of physicians and of members of family partnerships have also been on the "automatic" list from time to time. The Service also uses various sampling techniques to assign returns for automatic audit. In addition to the "automatics," returns are assigned for audit because of obvious errors on their face (such as the deduction of a loss on the sale of the taxpayer's residence) or because certain items seem to call for investigation (such as traveling and entertainment expenses out of proportion to gross or net income).

Experienced classifiers develop an uncanny ability to pick out returns that will be "productive of revenue" if audited.† One author has said this about the selection of returns for examination:

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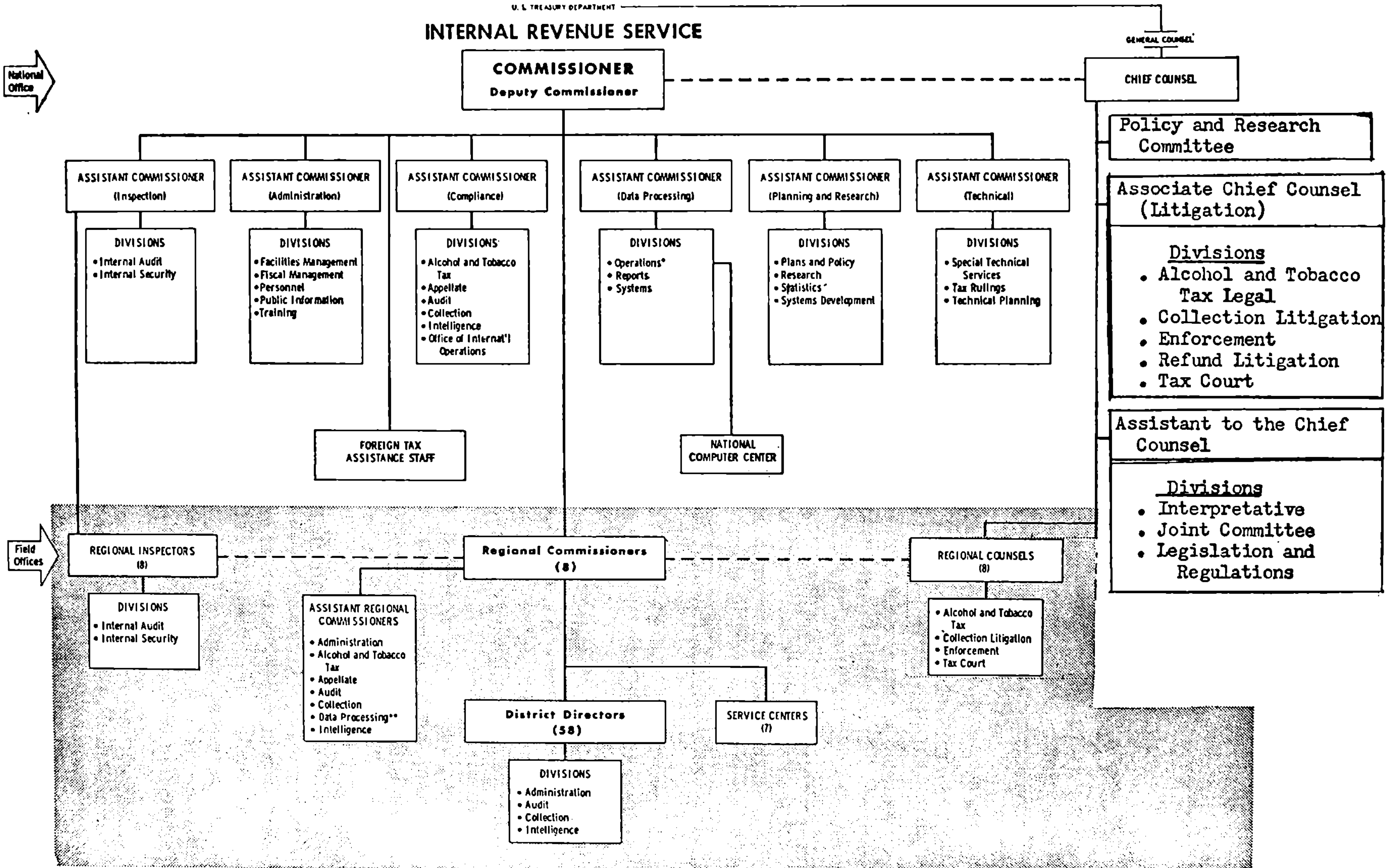
* For an organizational chart of the Internal Revenue Service, see facing page.

† In Announcement 60-88, 1960-45 I.R.B. 29, the Internal Revenue Service denied the widely held belief that revenue agents are rated according to the amount of additional tax they propose for assessment ("production"), and instituted a new program of agent-evaluation designed to correct this misconception. See also Hearings on Treasury-Post Office Appropriations for 1964,



*Including National Computer Center, Martinsburg, W. Va.
**Not in all regions.

Internal Revenue Service Organization

Those returns which are likely to be productive of revenue are set aside for examination. What causes those returns to be selected? The fact that they contain items involving:

— reasonableness of compensation or depreciation;
— bad debts in what are seemingly unreasonable amount;
— various deductions not substantiated or sufficiently explained, such as casualty losses, medical expenses, legal expenses, deductions from salaries, traveling and entertainment expenses, and the like; . . .
— losses from worthless stocks or bonds claimed as ordinary instead of capital losses;
— sales of securities for nominal sums, indicating the possibility of worthlessness in prior years;
— corporate returns which seem to indicate improper accumulation of surplus;
— substantial items of cancellation of indebtedness;
— substantial expense accruals shown in the closing balance sheet which might require the application of the two and a half months' rule [§267(a)(2)].

Generally speaking, most of the items mentioned, will lead to examination only if the amounts involved are substantial. Whether they are substantial is a relative matter, and the amounts must be considered in relation to the other figures on the return.

Aside from the list of items mentioned, which could be expanded indefinitely, there are a few other common matters which should be noted:

— Deductions with three zeros, i.e., in round figures, in cases where the figures would not ordinarily come out this way. Such figures indicate that they are estimates, rather than actual figures.
— The lumping together of items of deduction may give rise to examination. For example, all taxes may be deducted in one sum without any breakdown. Not infrequently it has been found that federal income taxes are included in such a deduction.
— The omission of schedules or substantiation where called for by the return or instructions may give rise to examination. [Arac, How to Effect Settlements at Various Stages, 9 N.Y.U. Inst. on Fed. Taxation (1951) 525, 526-527.]

Information returns. In selecting returns for examination, the Audit Division is not confined to the four corners of the return itself. The 327 million information returns received in 1963, mentioned above, included over 200 million Forms W-2 (employer's statement of wages paid and tax withheld) and about 100 million Forms 1099 (information returns on payments of dividends, interest, and certain other items). (For more on these sources of information, see page 22 supra.) Partnership returns, reporting each partner's share of the firm's profit or loss, and fiduciary returns, reporting the amounts distributed or distributable to beneficiaries, also provide information to be keyed in with the partner's or beneficiary's tax return.

In point of fact, these sources may flood the Audit Division with more information than it can put to use, especially if the taxpayer moves about during the year or if his employer, stock broker, bank, and others use variations of his name (e.g., John T. Miller, J. T. Miller, John Tracy Miller, etc.) in reporting their payments to him. To conquer the formidable task of digesting so much paper, the Internal Revenue Service has adopted an automatic data processing system using magnetic tapes and a nation-wide master file of taxpayers ("Automatic Data Processing," or "ADP"); an essential element in ADP is the use of "taxpayer account numbers" so that John Miller and John T. Miller will be instantly recognizable as the same person, and at the same time will not be confused with any of the thousands of other John Millers who are abroad in the land. Taxpayer account numbers are coordinated with the social security numbering system and for individuals are the same as their social security numbers. The Service instituted its ADP program in

House Committee on Appropriations, 88th Cong., 1st Sess. 378-379 and 387-389, for descriptions by the Internal Revenue Service of its audit program; infra page 901.

1962 in the Atlanta region, and has been gradually extending it to other regions.* See Caplin, The Taxpayer-Identifying Number System: The Key to Modern Tax Administration, 49 A.B.A.J. 1161 (1963); Symposium on Implications of Electronic Data Processing for Tax Administration and Tax Policy, 14 Nat. Tax J. 209 (1961); Conference on Automatic Data Processing, 14 Tax Exec. 115 (1962); Barron, How We Audit from Magnetic Tape, 40 Taxes 83 (1962).

Other sources of information: tax investigations, informers, etc. In addition to information that comes to the Audit Division as a matter of course through formal channels, the Service often hears from disgruntled bookkeepers, embittered ex-wives, business rivals, and other volunteers, especially if the taxpayer has engaged in fraud. Section 7623 authorizes the payment of rewards to informers; during the fiscal year 1963, 4200 claims were received, and $460,000 was paid to 750 claimants. During the same period, the Service collected $12.7 million in taxes, penalties, and interest as a result of information from informers. See Regs. §301.7623-1 (procedure for claiming reward; amount not normally to exceed 10 per cent of taxes, penalties, and fines collected from wrongdoers); Katzberg v. United States, 36 F. Supp. 1023 (Ct. Cl. 1941) (award is discretionary with Treasury). See also United States ex rel. Roberts v. Western Pacific R. Co., 190 F.2d 243 (9th Cir. 1951) (qui tam actions, allowed when government has been defrauded, not permissible in tax cases in absence of official consent under §7401).

Another informal source of information is the press: revenue agents may be stimulated to ask questions on reading that a baby-sitter has stolen $10,000 from a cardboard carton in a physician's clothes closet, that a hotel has been raided for permitting its rooms to be used by prostitutes, or that a small storekeeper has engaged in a very large real estate transaction. Banks are required to report large or unusual deposits or withdrawals of cash; see 31 C.F.R. §102.1 (transactions of $2500 or more in denominations of $100 or higher; transactions of $10,000 or more regardless of denomination; any transaction which in the judgment of the financial institution exceeds the customary conduct of the person involved).

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* In a statement before the House Committee on Appropriations in 1963, Commissioner Mortimer M. Caplin said of ADP:

"The public attention given to our automatic data-processing system, and our repeated suggestion that now is a good time for taxpayers to set their tax accounts straight, are producing effective results in voluntary disclosure of delinquencies.

"Let me tell you what has happened to illustrate this result. After this publicity about our automatic data-processing system, we began to get reports from district directors about taxpayers coming in to admit past delinquencies and seeking assistance in straightening out their tax affairs. We asked the district directors to send us periodic reports of these cases.

"In calendar year 1962, nearly 1,000 taxpayers voluntarily came forward with amended or delinquent returns attributing their disclosure to this publicity. On 450 of these, the districts did not report dollar value information, but on the remaining disclosures about $3 million in additional taxes was reported. Over half of the $3 million is from self-employed taxpayers, who are becoming increasingly aware of the potentiality of the automatic data-processing system for detecting failures to file. If this many are willing to step up and admit nonfiling, or other evasion, it is reasonable to suspect that many times that number have silently begun paying and reporting more accurately.

"This whole investment in automatic data-processing, besides being essential to efficient administration of the mounting tax return and information document workload, must be regarded as self-liquidating. The additional tax dollars which this system will produce will more than equal the additional cost. As a matter of fact, we expect it to produce considerably more." Hearings on Treasury-Post Office Appropriations for 1964, House Committee on Appropriations, 88th Cong., 1st Sess. 365.

The extent to which persons with extensive business or professional activities can succeed in escaping attention for many years is astonishing. See United States v. Doelker, 327 F.2d 343 (6th Cir. 1964) (certified public accountant with 12 to 14 employees, admitted to practice before Treasury in 1942, filed no tax returns for 12 years despite substantial income; her delinquency was discovered only when she applied for a renewal of her Treasury "card").

In examining a return, the Internal Revenue Service is armed with the power to take the testimony of the taxpayer and other persons having knowledge of the matters to be investigated (e.g., suppliers, customers, employees, banks, brokers, etc.), and to require them to produce their books and records. See §§7602-7606. So far as the taxpayer himself is concerned, the Service's inquisitorial power is limited by the unreasonable search and seizure clause of the Fourth Amendment and by the self-incrimination clause of the Fifth Amendment; and occasionally a taxpayer is able to prevent, or to limit the scope of, an investigation by virtue of §7605(b) (forbidding "unnecessary" investigations and permitting only one "inspection of a taxpayer's books of account" for each taxable year unless the Treasury gives him notice in writing that an additional inspection is "necessary"). The taxpayer's constitutional privileges do not enable him to prevent the Service from taking the testimony or inspecting the books of his customers, employees, bank, brokers, or others, however, and he may not even know that such a third-party investigation is under way. Most of the legal problems in tax investigations arise in fraud cases; and the growing body of law in this area is so intimately bound up with broad issues of constitutional law and criminal procedure as to resist separate examination, at least in brief. See Reisman v. Caplin, 375 U.S. 440 (1964) (procedure in enforcing administrative subpoenas); Colton v. United States, 306 F.2d 633 (2d Cir. 1962) (attorney-client privilege); Tillotson v. Boughner, 225 F. Supp. 45 (N.D. Ill. 1963) (attorney sending $215,500 to Treasury "conscience fund" on behalf of undisclosed taxpayer is subject to subpoena under §7602); Greene v. United States, 296 F.2d 841 (2d Cir. 1961) (no general duty to warn taxpayer of fraud investigation); United States v. Goodman, 190 F. Supp. 847 (N.D. Ill. 1961) (consent to search); United States v. Judson, 322 F.2d 460 (9th Cir. 1963) (subpoena directed to taxpayer's attorney quashed as to various documents, including net worth statements prepared by accountant for attorney's use); United States v. Kovel, 296 F.2d 918 (2d Cir. 1961) (attorney-client privilege); DeMasters v. Arend, 313 F.2d 79 (9th Cir. 1963) (examination of taxpayer's bank records); Reineman v. United States, 301 F.2d 267 (7th Cir. 1962) (assessment unlawful because based on unjustified re-examination of taxpayer's books); United States v. Powell, 325 F.2d 914 (3d Cir. 1963) (re-examination on ground of alleged fraud requires evidence); In re Leonardo, 208 F. Supp. 124 (N.D. Cal. 1962) (records obtained in violation of §7605(b) held not admissible in criminal proceeding); Wall v. Mitchell, 287 F.2d 31 (4th Cir. 1961) (use of subpoena for years barred by statute of limitations); page 118 supra (re "required records" doctrine); Note, The Inquisitorial Powers of the Federal Government in Third Party Tax Investigations, 41 Minn. L. Rev. 800 (1957); Orkin, The Attorney-Client Privilege in Tax Matters, 49 A.B.A.J. 794 (1963].

In the overwhelming majority of audits, of course, the taxpayer is entirely cooperative in making his records available. Except in fraud cases, and not always even then, there is seldom any advantage in seeking to withhold them.

Disposition of cases by Audit Division. If the examiner is satisfied that the return reports the proper amount of tax due, he will recommend that it be accepted as filed and, if this recommendation is approved by a reviewer, the taxpayer will be so notified. If, on the other hand, the examiner believes that an adjustment in favor of either the government or the taxpayer is required, he will inform the taxpayer of his findings and offer him an opportunity to execute an agreement form, ordinarily Form 870. The effect of this form (considered further infra p. 910) is often misunderstood. By signing it in a deficiency case, the taxpayer consents to the immediate assessment of the tax agreed upon, without the issuance of a 90-day letter. (This is the "notice of deficiency" described by §6212, usually called a "90-day letter" because it will be followed by an assessment of the

tax unless the taxpayer files a petition in the Tax Court within 90 days after the notice is mailed to him, as permitted by §6213.) Since the 90-day letter is the indispensable foundation for a petition to the Tax Court, a taxpayer waives his right to go to that court by executing Form 870. He does not, however, ordinarily lose his right to sue for a refund after paying the agreed deficiency. The Commissioner, for his part, waives the right to collect interest on the deficiency for the period commencing 30 days after Form 870 is executed and ending with the assessment itself. Since it may take some time to make the assessment, Form 870 protects the taxpayer against the running of interest during this period, though he need not pay the tax until it is assessed. It should be noted that the Commissioner does not waive his right to increase the deficiency should he later so determine, although if he does so the taxpayer's right to a 90-day letter and thus to file a petition with the Tax Court is reinstated. If an overassessment, rather than a deficiency, is found by the examiner, Form 870 authorizes the Service to proceed to make a refund without discussing the amount further with the taxpayer.

When the examiner explains his findings to the taxpayer, he may not wish to sign Form 870. In that event, the examiner will furnish the taxpayer with a brief written statement of the proposed adjustments and will advise him of his right to discuss the proposed adjustments in an informal conference with the examiner's group supervisor or, more frequently, with a member of a special conference staff in the Audit Division. In keeping with the purpose of the "informal conference," the examiner does not prepare a formal report nor is the taxpayer required to file a brief or other statement, lest positions become crystallized before the dispute has been fully discussed.

If after this informal conference the taxpayer accepts the examiner's conclusions (which may be modified as a result of the conference), he will have another opportunity to sign Form 870, and the examiner's report will be processed as previously described. If the taxpayer does not agree, the examiner prepares a report which (after review) is transmitted to the taxpayer with a so-called 30-day letter. Such a report and 30-day letter will also be sent to the taxpayer if he chose in the first instance to forego an informal conference.

The "30-day letter": protest to the Appellate Division. The 30-day letter sets in motion a somewhat more formal set of administrative maneuvers. Once more, the taxpayer is offered an opportunity to execute Form 870 or to pay the tax without waiting for an assessment. Alternatively, he may file a protest and request a conference with the Appellate Division.

The protest is a more or less elaborate statement of the taxpayer's objections to the proposed adjustments, together with a claim for any adjustments favorable to him that either were not previously discussed or were discussed and rejected. The conference is with the Appellate Division (formerly the "Appellate Staff" and, earlier, the "Technical Staff") of the Regional Commissioner's office, i.e., with a staff independent of the examiner previously dealt with.

If agreement is reached with the Appellate Division as a result of concessions by the taxpayer or the government or both, Form 870-AD is executed. This form is similar to Form 870, described above, but it purports to prevent the reopening of the case "in the absence of fraud, malfeasance, concealment or misrepresentation of material fact, or an important mistake in mathematical calculation." Whether it achieves this degree of finality is examined infra page 910. If no agreement is reached, the Service will issue the 90-day letter already described. During the 90-day period, the taxpayer may file a petition in the Tax Court; if he does so, assessment and collection of the tax will be stayed until the litigation is concluded, unless the government makes a "jeopardy assessment" (infra p. 928). Alterna-

tively, the taxpayer may pay the tax, either dropping the matter at this point or suing for a refund in a federal District Court or in the Court of Claims.

Sometimes the taxpayer who has received a 30-day letter will waive the opportunity to confer with the Appellate Division and ask that the 90-day letter be issued without conference. This may be done on the theory that he will have a better opportunity to settle the case after he has demonstrated his confidence by filing a petition in the Tax Court than while the matter is in a nondocketed status.

For the fiscal year 1963, the Appellate Division handled about 20,000 cases. Almost 12,000 were settled by agreement without issuance of a 90-day letter. Only 5500 resulted in Tax Court petitions, and less than 1000 of these cases went to trial.

The audit process: evaluation. During the fiscal year 1963, 3.5 million individual and 150,000 corporate income tax returns were examined. These examinations led to recommendations for $2.1 billion of additional tax and penalties and $150 million or refunds or credits.

In an effort to test the effectiveness of the audit process and to ascertain how many returns might be "productive of revenue" if audited, the Service in 1949 conducted an "Audit Control Program." The results of part of this program, an intensive examination of a sample of individual returns for 1948, were illuminating. The study indicated that one quarter of all individual returns for 1948 contained errors of $2 of tax or more, 90 per cent of which were in favor of the taxpayer. The percentage of erroneous returns, not surprisingly, steadily increased with income, with 72 per cent of returns reporting $100,000 of income or more containing errors. The average error on returns reporting $100,000 of income or more was over $2500. In the aggregate, individual tax liability was understated by about $1.4 billion, almost 10 per cent of the total liability actually reported on these individual returns. A substantial part of this liability, which if detected would be increased by interest and penalties, escaped discovery because of lack of manpower. See Farioletti, Some Results from the First Year's Audit Control Program of the Bureau of Internal Revenue, 5 Nat. Tax J. 65 (1952); Bureau of Internal Revenue, The Audit Control Program: A Summary of Preliminary Results. See also, on the question of "disappearing income," Holland and Kahn, Comparison of Personal and Taxable Income, in Joint Committee on the Economic Report, Federal Tax Policy for Economic Growth and Stability, 84th Cong., 1st Sess. 313 (1955).

The Audit Control Program also demonstrated that the expense of auditing tax returns is far below its yield: an examination of Forms 1040A for 1948 (adjusted income less than $5000, not more than $100 of which was from wages not subject to withholding and from dividends and interest) would have produced $9400 per year per examiner; and the potential yield rises steadily with the size of the returns being examined, with an examination of returns reporting $100,000 of income or more producing $197,000 of revenue per examiner per year. The Audit Control Program also increased the Service's knowledge of the type of errors made by various classes of taxpayers. The principal error on small returns, for example, was the claiming of unwarranted personal exemptions; this error was rarely found on large returns. Moreover, a taxpayer rarely incorrectly claimed or invented a wife or child, but erroneous deductions for parents and other relatives were common. Thus, out of 43 million small returns listing no dependent relatives (i.e., persons other than a spouse and children), only one out of 53 contained an exemption error; out of 6 million such returns listing dependent relatives, one out of five was erroneous. Errors on small returns would undoubtedly be far more numerous were it not for the optional standard deduction. Only one return out of 250 con-

tained an error in using the standard deduction (presumably such errors as the taking of personal deductions in addition to the standard deduction or errors in computing the standard deduction itself), but out of 9 million returns itemizing personal deductions (taxes, medical expenses, charitable contributions, and interest), 3 million were erroneous.

Economic and statutory changes since the 1949 Audit Control Program no doubt have made many of its specific findings obsolete. At this writing (1964), the Internal Revenue Service is about to make an intensive examination of 100,000 individual returns, selected by a scientific sampling method, to ascertain the types, size, and frequency of mistakes occurring currently, as a guide to its audit program. The Service has not announced whether the findings of this "Taxpayer Compliance Measurement Program" will be made public.

Obviously, intensive examination of returns is not the only remedy — or indeed the best — for many types of errors. In recognition of the frequency of error in dependency claims for dependent relatives, the returns for 1951 and later years have required the taxpayer claiming such exemptions to answer specific questions as to the amount of support contributed by him and by others and the gross income of the dependent. This step should bring home to the taxpayer the requirements for claiming a dependency exemption more effectively than the older return, which required only the relative's name, relationship, and address. Form 1040 was also revised to require an itemization of interest and dividend income, whereas previously a simple total was sufficient.

In his Tax Message of April 20, 1961, President Kennedy asked Congress to require withholding of tax at the source on payments of dividends and interest. In support of the proposal, the Internal Revenue Service estimated that $3.8 billion of dividends and interests were omitted from tax returns in 1959, of which $2.8 billion would have been subject to tax of about $0.9 billion. H.R. Doc. No. 140, 87th Cong., 1st Sess. 34 (1961); see pp. 142-166 for methodology of estimates.

Congress refused to authorize withholding, however, and instead strengthened the provisions for filing information returns by making it mandatory to report the payment of dividends and certain types of interest (primarily interest paid by banks, savings and loan associations, and insurance companies) of $10 or more, and by prescribing civil penalties for non-compliance. See §6042 (dividends) and §6049 (interest payments).

For taxpayers as a whole, information returns, withholding of tax, intelligible forms, and dispersion of instructions for completing the return are basic steps in enforcement. Another simple technique would be to provide in the Code that items like fellowships should be deducted, rather than excluded, from income; the use of a deduction requires the item to be revealed on the return, and thus facilitates the correction of errors, while a statutory exclusion means that the item will not be mentioned on the return, so that there is less chance that the Service will be aware that the taxpayer has misunderstood the scope of the statute. Improvement in such techniques for preventing or easily detecting simple errors would leave the Service's examiners with more time for auditing the complex returns, while scientific studies like the Taxpayer Compliance Measurement Program can sharpen the methods of identifying those returns in need of audit.

No matter how the Service may improve its criteria for selecting returns that will be "productive of income," however, there will remain knotty questions of policy in the assigning of a limited number of man-hours. If the large returns will produce the largest additional revenue per hour of examination, should agents be assigned exclusively to this work, at least until further studies show that neglect of the small returns has increased the errors in them? If physicians characteristically receive and omit larger amounts of cash fees than lawyers, should

the former group be subjected to automatic audit? If tracking down the errors of gamblers and bookmakers is more expensive per dollar of revenue produced than examining the returns of businessmen, how many of a limited group of agents should be assigned to "racketeer" duty? Would a wholly random selection of returns for audit produce a psychological effect upon taxpayers compensating in the long run for initially unrewarding results? In the same vein, would it be desirable that every taxpayer be subjected to at least one examination periodically? How does the audit of one taxpayer, or a group of taxpayers, affect others who hear of the audit? The findings of the 1949 Audit Control Program that are summarized above were based on the assumption that the representative sample disclosed the percentage of error across the board. This may be true for any one year's returns, but what will be the effect on the returns for next year, if, before they are filed, extensive audits have been conducted on last year's returns? Is a door-to-door canvass a desirable technique for detecting persons who fail to file or for frightening them into coming forward?* Will such methods earn the Service the hostility of law-abiding citizens? Are they compatible with democratic government?

An official statement in 1962 of the audit objectives of the Internal Revenue Service, by Commissioner Mortimer M. Caplin, made the following points, among others:

Some 97 percent of our total receipts come from self-reporting by American taxpayers, with the remainder from our direct enforcement activities. Our ability to collect revenue at a cost of less than one-half cent for every dollar raised rests largely on maintaining the highest possible level of voluntary compliance.

While vigorous direct enforcement is vital to attaining effective compliance, previous efforts of the Service were overly oriented toward direct enforcement dollars; and insufficient emphasis and resources had been allocated to encouraging more accurate self-assessment. . . .

In brief, while we are seeking vigorous enforcement and broader audit coverage, special efforts are being made to attain a higher degree of voluntary compliance — and in that way to raise more revenue at a lower cost.

On the other hand, if the new direction is pursued without limitation or reservation, the inevitable drop in direct enforcement statistics becomes so severe that, as a practical matter, it becomes unacceptable. With this in mind, we have recently taken steps to moderate the statistical impact of the new direction while carefully preserving the basic objectives and underlying philosophy.

For example, we have made it clear that the concept does not contemplate an inordinate expenditure of time on simple individual returns or excessive documentation of the examination of more complex returns. We are reexamining the examination mix to the end that low dollar-producing areas will be given adequate attention but will not drain an unwarranted proportion of our effort from areas which produce a high dollar return. With the same objective in mind, we are taking steps to increase the percentage of agent time devoted to examination as contrasted with nonproductive activities. . . .

QUOTAS

Under previous field practice, dollar and case quotas were often imposed on Revenue personnel in administering the tax laws. This led to abuses and resentment, both within and without the Service. Indeed, at my confirmation hearing before the Senate Finance Committee, this issue was raised, and I made clear my strong opposition to a quota approach in the examination of tax returns. Consequently, we have prohibited our group supervisors from maintaining any quota system, and have directed them to evaluate our

* See §7601(a), providing that the Secretary shall, to the extent he deems practicable, "cause officers or employees of the Treasury Department to proceed, from time to time, through each internal revenue district and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax. . . ."

professional enforcement personnel on a much broader basis — overall performance, professional attitude, ability to identify and raise significant tax issues, courtesy, and manner of dealing with taxpayers, contribution to improving voluntary compliance.

We want our personnel to function as professionals and to be productive in the best sense of the word — that is, to make effective use of their time, not only in direct enforcement activities, but in the more important area of strengthening accurate self-assessment.

Quality Audit

We have recently completed a booklet, "Quality Audit Guidelines," to serve as an additional tool for our agents in making detailed audits in appropriate cases. This is not intended as a blanket program. Rather, the depth of an audit is left to the combined judgment of supervisors and agents. Agents obviously cannot undertake the type of audit made by CPA's. Nevertheless, they should be allowed sufficient time, in appropriate cases, to make an adequate tax audit to probe areas of error and tax avoidance and to contribute to better compliance in the future.

When, in the past, agents believed they were under the compulsion of a quota they often made superficial examinations to close cases quickly and to raise direct enforcement dollars. This often led to contempt by practitioners of the practices of the Service, and also to so-called baited returns — with deliberate and obvious errors inserted in returns to lead the agent to focus on those issues alone. As a result of our change in policy, we now have the difficult task of making it clear that quality audits are essentially judgment decisions and that they are not to be applied in all cases. Our quality audit guidelines should help in monitoring this concept, and we are involved in working with field personnel and with supervision at all levels to bring this into proper balance.

Audit Selection Pattern

In the past, the returns selected for audit were focused almost entirely on those estimated to be most productive of additional revenue. As a consequence, many categories of tax returns had little likelihood of ever being examined, even those which contained serious abuse potential. For example, tax-exempt organizations were rarely audited, giving rise to possible abuse which now is attracting public and congressional attention. An important part of our new audit selection program is aimed at the abuse areas and at some sampling of all categories of returns, to assure Americans at all income levels that they may be subject to an examination. Tax-exempt organizations, returns evidencing foreign transactions, returns with so-called hobby losses, etc., are now being given greater coverage and study. At the same time, as is indicated above, we are alert to the impact of this selection program on enforcement results and have taken actions to assure balance between the two objectives.

Abuse Areas

In addition to a broader audit program, we are generally concentrating on curbing areas of ostentatious tax abuse. This may not always be productive of the highest degree of direct enforcement dollars, but we believe it will have a salutary effect on taxpayers at large. By knowing that we are concerned and taking action against these abuses, taxpayers should have a greater degree of confidence in the efficiency and fairness of tax administration. Inventories, travel and entertainment deductions, hobby businesses, charitable gifts through works of art, and so-called charity parties, various security transactions and the like, are all within our efforts aimed at tax abuses.

Taxpayer Assistance and Education

Over recent years assistance to taxpayers in preparing returns and answering tax questions was held to a minimum. We have revitalized this program because the American taxpayer is entitled to this type of aid, and because it contributed to fairer tax administration and better reporting. In brief, with qualified personnel to give accurate answers to tax inquiries and to assist in return preparation, we believe we are getting improved compliance.

During fiscal 1962, taxpayer assistance was increased approximately 20 percent over the previous year. At the same time, we expanded our publication program to include "Mr.

Businessman's Kit" — a collection of forms and tax information which is being delivered to newly formed businesses. But these programs also are being monitored, to be sure that too many of our highest grade agents are not diverted from other important and productive activities.

We have expanded our programs in the public schools and in the colleges to present educational material for our younger people. Our materials have been sharply revised this year, and we are focusing not only on the mechanics of making out tax returns, but on the place of taxation in a democratic system and its significance to the welfare of our country. [Memorandum to Secretary of the Treasury, reprinted in Hearings, on Treasury-Post Office Appropriations for 1964, House Committee on Appropriations, 88th Cong., 1st Sess. 377-379.]

The flow of cases in the Internal Revenue Service and the courts. The tables on the two following pages reflect the flow of tax returns and cases in the Internal Revenue Service and the courts.

NOTE

1. *Relation of Treasury to administration of tax laws.* From time to time suggestions have been made that the task of administering the tax laws be placed in an agency independent of the Treasury Department, partly to immunize administration from the Treasury's views of fiscal policy. See Surrey, A Comment on the Proposal to Separate the Bureau of Internal Revenue from the Treasury Department, 8 Tax L. Rev. 155 (1953). As the *Dobson* case, supra page 862, points out, the Tax Court is the descendant of an office in the Bureau of Internal Revenue.

2. *References.* On audit procedures, see Murphy, Selection of Income Tax Returns for Audit, 12 Nat. Tax J. 232 (1959) (New York state procedures); Farnsworth & Chambers Co. v. Phinney, 178 F. Supp. 330 (S.D. Tex. 1959) (description of procedure in District Director's office).

On compliance, see Groves, Empirical Studies of Income-Tax Compliance, 11 Nat. Tax J. 291 (1958); Stocker and Ellickson, How Fully Do Farmers Report Their Incomes? 12 id. 116 (1959); Gardner, Sources of Farm Income Underreporting: Gross Receipts or Deductions? 12 id. 374; Adler, Taxpayer Compliance in Reporting Dividend Income in Wisconsin, 13 id. 86 (1960).

Conference and appellate procedure: Alexander, Conference and Review Procedures in Field Audit Divisions; How New Procedures Affect the Handling of Tax Cases, 21 N.Y.U. Inst. on Fed. Taxation 95 (1963); Hobbet and Donaldson, Administrative Procedure in Federal Tax Cases: Opportunities and Bramblebush, 44 Marq. L. Rev. 312 (1961).

See generally Goodrich and Redman, Procedure Before the Internal Revenue Service (American Law Institute, 1957).

The 90-day letter: Brodsky, Adequacy of Notice of Deficiency, 18 N.Y.U. Inst. on Fed. Taxation 997 (1960).

2. *Refund Cases*

Most refunds result from excessive prepayments of the individual income tax, caused by overwithholding by employers (e.g., because a taxpayer failed to inform his employer of a new dependent, worked only part of the year, etc.) and by payments of estimated tax based on overestimates of income. For the fiscal year 1963, for example, refunds of excessive prepayment of tax by individuals amounted to nearly $5.4 billion. (Interest is not due on refunds, under §6611(e), if paid within 45 days of the date on which the return is due, ordinarily April 15.) These refunds are made more or less automatically, and when the returns involved are audited, some require readjustments in the government's favor. This may sometimes mean a revenue loss, if the taxpayer in question is insolvent or cannot be found, and in any event it is expensive to pursue the taxpayer for a refund of the refund.

Work Flow in the Internal Revenue Service and the Courts, Fiscal Years 1963 and 1962

Item	1963	1962
	Returns	
Tax returns filed, total	97,832,977	96,511,219
Individual income	63,679,166	62,487,325
Corporation income	1,291,039	1,231,738
Estate and gift	179,446	168,491
Employment	21,139,735	20,931,576
Excise	3,954,416	4,009,315
Other income	7,589,175	7,682,774
Income, Estate, and Gift Taxes		
Number of returns examined	3,673,939	3,279,670
Returns with adjustments proposed by audit divisions	2,339,658	2,267,735
Disposed of by audit divisions:		
Agreed, paid, or defaulted	2,102,069	2,068,170
Civil cases	Cases	
Total received in appellate divisions	18,326	15,804
Disposed of by appellate divisions:		
Agreed, paid, or defaulted	14,179	12,687
Courts of original jurisdiction:		
Tax Court:		
Total petitioned to Tax Court	5,376	4,749
Dismissed	266	228
Settled by stipulation	4,371	4,890
Settled by Tax Court decision	1,089	882
Decided by Tax Court but appealed	390	403
District courts and Court of Claims:		
Total filed in district courts and Court of Claims	1,407	1,364
Settled in district courts and Court of Claims	764	659
Decided by district courts and Court of Claims	486	505
Courts of appeals:		
Settled by courts of appeals decision	349	414
Favorable to Government	229	268
Favorable to taxpayers	78	113
Modified	42	33
Decided by courts of appeals but reviewed by Supreme Court	6	6
Supreme Court:		
Settled by Supreme Court decision	7	7
Fraud cases[1]		
Received for full-scale investigation in intelligence divisions	2,239	2,200
Disposed of by intelligence divisions:		
Prosecution recommended	994	955
Prosecution not recommended	1,228	1,166
Disposed of by Office of Chief Counsel:		
Prosecution not warranted	151	165
Department of Justice declined	77	77
Prosecutions	1,405	1,143

[1] Includes excise tax cases.

AMOUNTS OF REVENUE INVOLVED AT EACH LEVEL OF THE TAX SYSTEM, FISCAL YEARS 1963 AND 1962

[Millions of dollars]

Item	1963	1962
Internal revenue collections, total	105,925	99,441
Individual income taxes, total	52,988	50,650
Withholding	38,719	36,246
Other	14,269	14,403
Corporation income taxes	22,336	21,296
Estate and gift taxes	2,187	2,035
Employment taxes	15,004	12,708
Excise taxes	13,410	12,752
Income, Estate, and Gift Taxes		
Civil cases		
Additional tax and penalties in cases disposed of in audit divisions by agreement, payment, or default	1,147	1,042
Additional tax and penalties in cases disposed of in appellate divisions by agreement, payment, or default	179	146
Additional tax and penalties determined by settlement in Tax Court	81	63
Additional tax and penalties determined by Tax Court decision:		
Dismissed	4	4
Decision on merits	26	27
Additional tax and penalties in cases decided by Supreme Court and courts of appeals	9	12
Amount refunded to taxpayers as a result of refund suits	37	25
Fraud cases[1]		
Deficiencies and penalties in cases disposed of in intelligence divisions:		
Prosecution recommended	116	103
Prosecution not recommended	29	22

[1] Includes excise taxes.

Another time when an overpayment of tax may come to the attention of the Service is upon audit of the return. It has already been seen that the examiner may propose an overassessment instead of a deficiency. Or, when he disputes the year in which a particular item is deducted, he may propose a deficiency for one year and an overassessment for another. Likewise, in family partnership or *Clifford* trust cases, a proposed deficiency for one taxpayer may be accompanied by a proposed overassessment for a related taxpayer. The taxpayer may agree to the proposed overassessment, in which event he will receive a refund or credit. If he objects to the overassessment (either because he thinks it is too small or because it is linked to a deficiency that he does not accept), he may obtain an informal conference, at which the examiner's action may be either upheld or modified.

It is very important to note that there will be no 90-day letter, or opportunity to go to the Tax Court, on an overassessment. That court has jurisdiction only when a deficiency is asserted. To be sure, when a deficiency has been asserted, the Tax Court may redetermine the entire tax liability for that year and thus find that the taxpayer has overpaid. It cannot, however, take jurisdiction of a year for which no deficiency has been asserted. Thus, whenever the taxpayer feels that he

has overpaid by more than the overassessment proposed by the Service, his only recourse is a claim for refund and, if it is rejected or not acted upon, a suit in a United States District Court or in the Court of Claims. Moreover, just as the taxpayer may "agree" to a deficiency by signing Form 870, pay the resulting assessment, and then sue for a refund, so he may "accept" an overassessment on Form 870, receive the refund or credit so calculated, and then sue for any additional refund to which he may be entitled.

A tax refund claim may also arise because the taxpayer, after filing his return and paying the tax reported, finds on his own initiative that he miscalculated his liability. It will be necessary for him to file a claim for refund, since until such a claim has been rejected by the Service or has been before the Service for six months without action, he may not sue in the District Court or in the Court of Claims. Since the Tax Court, as already explained, has jurisdiction only when the Service asserts a deficiency, the taxpayer in the situation just described cannot go to the Tax Court.

Thus, whether the taxpayer is acting on his own initiative or is objecting to an overassessment as too niggardly, he must file a refund claim with the Service. Such a claim has a double aspect: It sets in motion administrative procedure (substantially the same as in deficiency cases) to consider the merits of the taxpayer's position; and it is the indispensable first step toward litigation.* The taxpayer with a possible refund claim must think carefully before he sets the Service in motion, since the return itself and possibly returns for other years as well, not just the refund claim, will come under scrutiny. It may be better to let sleeping dogs lie.

If a refund claim is to be filed, it must be drafted with a realization that it is a kind of pleading for any subsequent litigation and will, therefore, restrict the taxpayer in the issues that may be raised later. See §7422(a). In this respect, refund procedure is quite different from deficiency procedure. The taxpayer may resist a deficiency in the Tax Court on any ground he wishes, whether it has been argued in the Service or not. Indeed, when an examiner first proposes a deficiency, the taxpayer may request that the 90-day letter be issued without further ado and then file his petition in the Tax Court without having previously informed the Service why he thinks the deficiency is improper. In suing for a refund, however, he is confined by the limits he himself set out in the claim filed with the Service. See Sicanoff Vegetable Oil Corp. v. United States, 181 F. Supp. 265 (Ct. Cl. 1960), and cases there cited.

NOTE

1. *Deficiencies, refunds, and sleeping dogs.* Once a taxpayer gets into the Tax Court, the government may move in its answer or by an amended answer to increase the deficiency claimed in the 90-day letter, even though this involves the introduction of other issues; and the taxpayer may win on the deficiency asserted in the 90-day letter, but lose on the other items and thus find himself compelled to pay a deficiency larger than was originally claimed. Moreover, the government's answer or amended answer can raise additional issues after the statute of limitations for assessing a further deficiency for the year has run. See Raskob v. Commissioner, 37 B.T.A. 1283 (1938), where the 90-day letter claimed a deficiency of less than $16,000, and the government's answer increased the deficiency by more than $1,000,000.

In the District Court, however, while a taxpayer cannot recover a refund on one item if the government can establish there was an offsetting error for the same year in an equal or larger amount, there can be no money judgment against him unless the government

* On rare occasions, however, the taxpayer may be able to sue in the Court of Claims on an account stated without filing a claim for refund. See Note, 56 Harv. L. Rev. 115 (1942).

can still assess a deficiency. Thus, if the taxpayer who has a valid claim for refund waits until just before the expiration of the period of limitations, he may file his claim knowing that there is no longer enough time for the government to assess a deficiency. If there are other items as to which he may have underpaid for the year in question, they can be employed by the government as offsets (if they are resolved against the taxpayer), but they cannot be used for a money judgment against him. This technique might have been effective in Bush v. United States, 109 F. Supp. 254 (Ct. Cl. 1953), where a claim for refund in an apparently small amount was filed before the statute of limitations had run on the assessment of deficiencies, and where an audit brought on by the refund claim led to the assessment of deficiencies of about $1,600,000.

2. *Recovery of erroneous refunds.* Neither the allowance of a refund claim nor its payment bars the subsequent timely assertion of a deficiency. Burnet v. Porter, 283 U.S. 230 (1931). This is especially important in the case of administrative refunds resulting from an alleged overpayment by withheld taxes or amounts paid on estimates, where the refund is ordinarily made, as explained supra page 903, before audit of the return. Milleg v. Commissioner, 19 T.C. 395 (1952). Moreover, even though it may be too late to assess additional tax, an erroneous refund may be recovered by suit by the United States within two years after it was made or, in the case of a refund induced by fraud or material misrepresentation, within five years. §§7405 and 6532(b).

3. *References.* Pomeroy, Refund Claims: Litigation, 21 N.Y.U. Inst. on Fed. Taxation 129 (1963): Clark, Practical Considerations in Obtaining Rulings and in Filing Claims for Refund, 1957 Tulane Tax Inst. 257, 293; Stark, Claims for Refund of Federal Taxes, 41 Iowa L. Rev. 496 (1956).

3. *Finality in the Administrative Process*

a. STATUTES OF LIMITATIONS

If a return is not subjected to audit or if an examiner recommends that it be accepted as filed, the taxpayer will rarely hear anything more about it. Unless he enters into a closing agreement or compromise (rarely used procedures discussed infra), however, only the running of the statute of limitations will supply final protection against a re-examination of the return. To the effect that the statute of limitations in tax cases not only bars the remedy, but also extinguishes the liability (contrary to the usual rule applicable to limitations), see Diamond Gardner Corp. v. Commissioner, 38 T.C. 875, 879-881 (1962).

The principal statute of limitations is §6501(a), providing that the assessment must be made within three years after the return has been filed. No suit for collection of the tax without assessment may be commenced after this period has expired. To the three-year period provided by §6501(a), there are certain exceptions, of which the most important are:

(a) *Twenty-five per cent omission from gross income.* If the taxpayer omitted from gross income more than 25 per cent of the amount reported on the return, the period for assessment is extended to six years. §6501(e)(1). The 1954 Code provides a partial definition of the term "gross income" for the extended statute of limitations; for the difficulties under the 1939 Code with this term, which are partly obviated by the 1954 changes, see Richards, The Extended Statute of Limitations on Assessment, 12 Tax L. Rev. 297 (1957).

(b) *No return.* If the taxpayer failed to file a return (even though the omission was innocent), there is no period of limitations. §6501(c)(3). For the meaning of "return," see page 947 infra.

(c) *Fraud.* There is no statute of limitations on a taxable year for which the taxpayer filed a false or fraudulent return. §6501(c)(1); see Lowy v. Commissioner, 288 F.2d 517 (2d Cir. 1961) (fraud on one item opens the way to assessment

of a deficiency for all items). The fact that the taxpayer's civil liability (including liability for fraud penalties) is not barred by the statute of limitations if he files a false or fraudulent return should not be confused with the question of a statute of limitations on a criminal prosecution, for which the period of limitations is either six years (attempting to evade tax, assisting in preparation of false return, willful failure to pay tax or to file return, etc.) or three years (certain other offenses). §6531.

(d) *Waiver: Form 872.* If the taxpayer and Commissioner consent to an extension of the time before its expiration, the period will be extended as agreed. §6501(c)(4). Form 872 is ordinarily used for this purpose, and will often be proffered to the taxpayer when the statute of limitations is about to run if an audit is in progress or if decision on some matter is being held in abeyance pending litigation in another case. If the taxpayer refuses to consent to an extension of the time for assessment, the Service may make an assessment or a jeopardy assessment without waiting longer; see also Cincotta v. Commissioner, ¶60,045 P-H Memo T.C. (use of 90-day letter to extend statute of limitations on the taxpayer's failure to sign Form 872).

(e) *Request for prompt audit.* In some circumstances, a taxpayer who wishes to shorten the period of limitations (e.g., the executor of a decedent's estate who wants to have the estate's income tax liability determined before distributing its assets to the beneficiaries; a corporation that is about to liquidate) may ask for a "fast audit" under §6501(d), in which event any assessment must be made within 18 months after the request.

Once a tax has been assessed, the Internal Revenue Service has six years to collect it by distraint or suit. §6502(a).

See generally Levin, Civil Liability and the Statute of Limitations, 12 N.Y.U. Inst. on Fed. Taxation 891 (1954); Burns, Statute of Limitations in Fraud Cases, id. at 43; Emmanuel, The Effect of Waivers in Federal Income Tax Cases, 3 U. of Fla. L. Rev. 176, 184-191 (1950).

b. CLOSING AGREEMENTS

Section 7121 of the 1954 Code, relating to closing agreements, is substantially the same as §3760 of the 1939 Code.

Pursuant to §7121, the government will sometimes enter into a "closing agreement" to fix the taxpayer's liability for a past year or to determine the tax consequences of a specific item for a past or future year. Under §7121, such a closing agreement is "final and conclusive" except for fraud, malfeasance, or misrepresentation of a material fact. The Regulations, however, provide that an agreement with respect to a future period must also provide that it is subject "to any change in, or modification of, the law enacted subsequent to the date of the agreement." Regs. §301.7121-1(c). Presumably the reference to the "enactment" of a law means that a change in the applicable statutes will permit a re-examination, but not a change in judicial interpretation.

The Regulations state that a closing agreement may be entered into "in any case in which there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined by the Commissioner that the United States will sustain no disadvantage through consummation of such an agreement." The current Regulations give only one example of an appropriate application for a closing agreement (to fix the basis under §1053 of

property acquired before March 1, 1913, in anticipation of a sale),* but an earlier announcement set out the following:

(a) Estates, where the fiduciary desires a closing agreement in order that he may be discharged by the court;
(b) Trusts, or receiverships, where the fiduciary desires a final determination before distribution is made;
(c) Corporations in process of liquidation or dissolution which desire closing agreements in order to wind up their affairs;
(d) Cases where, in connection with the taxpayer's financial affairs, creditors demand authentic evidence of the status of the taxpayer's tax liability;
(e) Cases where taxpayers desire to follow the consistent practice of closing their returns from year to year. [Mim. 6383, 1949-2 C.B. 100.]

While the closing agreement is theoretically a useful technique for both the taxpayer and the government, the finality which it produces leads to extreme caution by the officials who must pass on an application for a closing agreement. In the fiscal year 1962, for example, the Service disposed of only 9 applications relating to prospective transactions and 65 relating to completed transactions.

C. COMPROMISES

Section 7122 of the 1954 Code, relating to compromises, is substantially the same as §3761 of the 1939 Code.

Although nothing in §7122 requires it, compromises are used primarily in cases of doubtful ability to pay, whether the liability of the taxpayer is disputed or not. For examples of intra-office memoranda of the Internal Revenue Service recommending acceptance or rejection of offers in compromise, see Exhibits A and F, Rev. Rul. 117, 1953-1 C.B. 498, which illustrates the government's emphasis on the forced sale value of the taxpayer's assets. Exhibit F also contains a so-called "collateral agreement," under which the taxpayer offers to pay not only a fixed amount to compromise his tax liability, but also an additional amount contingent on his future income. By such a collateral agreement the taxpayer may also agree to give up some tax benefit, present or potential, to limit his salary from a controlled corporation, etc., as part consideration to the government for accepting the offer in compromise.

See Hamilton v. United States, 324 F.2d 960 (Ct. Cl. 1963) (formal requirements for compromise); United States v. McCue, 301 F.2d 452 (2d Cir. 1962) (re compromise of criminal liability).

In the fiscal year 1963, the Service accepted about 800 offers in compromise of liability for income, excess profits, estate and gift taxes, and about 1650 offers in such cases were rejected or withdrawn. The accepted offers totaled about $4 million against claimed liabilities of about $16 million. Accepted compromises are open to public inspection. Regs. §301.6103(a)-1(j).

NOTE

References. Horne, Offers in Compromise, 16 N.Y.U. Inst. on Fed. Taxation 503 (1958); Tannenbaum, Compromises Based on Inability to Pay, 10 N.Y.U. Inst. on Fed. Taxation 839 (1952); Paul, Federal Tax Compromises and Prospective Regulations, in his Selected Studies in Federal Taxation, Second Series (1938) 53.

* See Couzens v. Commissioner, infra page 919, involving a ruling (not a closing agreement) in such a case.

d. FORM 870 AND OTHER SETTLEMENTS

Form 870 is used to "settle" a tax case when it is in the Audit Division of the District Director's Office. By executing this form (entitled "Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment") in a deficiency case, the taxpayer waives the restrictions of §6213(a), which means that he loses his right to contest the deficiency in the Tax Court and consents to an immediate assessment and collection of the agreed deficiency. See United States v. Price, 361 U.S. 304 (1960). (In an overassessment case, Form 870 authorizes the government to process the agreed overassessment, for refund or credit to the taxpayer. Presumably the government could make the refund or credit even if the taxpayer did not agree to it.) Form 870 also provides:

> The execution and filing of this form . . . will expedite the adjustment of your tax liability as indicated above. It is not, however, a final closing agreement under section 7121 of the Internal Revenue Code of 1954, and does not, therefore, preclude the assertion of a deficiency or a further deficiency in the manner provided by law should it subsequently be determined that additional tax is due, nor does it extend the statutory period of limitation for refund, assessment, or collection of the tax.

Both the government's procedural regulations and the cases hold that Form 870 is no more than a waiver by the taxpayer of the procedural right to contest the deficiency in the Tax Court, and that it does not prevent him from suing in the District Court or Court of Claims for a refund of the deficiency after it has been assessed and collected. Regs. §601.105(b)(4), 1955-2 C.B. 921, 930; Payson v. Commissioner, 166 F.2d 1008 (2d Cir. 1948); but see Cain v. United States, 255 F.2d 193 (8th Cir. 1958) (taxpayer barred by equitable estoppel from claiming a refund after executing Form 874, despite inclusion of provision — identical with reservation in Form 870 — that the government may assert a further deficiency). In practice, the execution of Form 870 ordinarily closes the case so far as the government is concerned, despite the reservation of the right to assert an additional deficiency.

If a tax case is "settled" with the Appellate Division, Form 870-AD is used, rather than Form 870. By executing Form 870-AD in a deficiency case, the taxpayer "offers" to waive the restrictions of §6213(a) and to consent to the assessment and collection of the agreed deficiency. The form goes on to provide:

> This offer is subject to acceptance by or on behalf of the Commissioner of Internal Revenue. It shall take effect as a waiver of restrictions on the date it is accepted. Unless and until it is accepted, it shall have no force or effect.
>
> If this proposal is accepted by or on behalf of the Commissioner, the case shall not be reopened in the absence of fraud, malfeasance, concealment or misrepresentation of material fact, an important mistake in mathematical calculation, or an excessive tentative allowance of a net operating loss carry-back; and no claim for refund shall be filed or prosecuted for the year(s) above stated other than for the amounts of overassessment shown above and amounts attributed to a claimed deduction for a net operating loss carry-back provided by law.
>
> NOTE. — The execution and filing of this offer will expedite the adjustment of your tax liability. It is not, however, a final closing agreement under section 7121 of the Internal Revenue Code of 1954, nor does it extend the statutory period of limitation for refund, assessment, or collection of the tax.

Note that Form 870-AD provides that "the case shall not be reopened" except for fraud, important mathematical mistake, etc., and that "no claim for refund shall be filed or prosecuted." The enforceability of these commitments has been frequently litigated. The case that follows is concerned with Form 870-TS, a

predecessor of the current form ("TS" meaning Technical Staff, the forerunner of the present Appellate Division). Form 870-TS also contained an agreement by the taxpayer to execute a closing agreement under §3760 of the 1939 Code (1954 Code, §7121), however, which is not included in Form 870-AD.

GUGGENHEIM v. UNITED STATES

77 F. Supp. 186 (Ct. Cl. 1948), cert. denied, 335 U.S. 908, rehearing denied, 336 U.S. 911 (1949)

Before JONES, Chief Justice, and HOWELL, MADDEN, WHITAKER, and LITTLETON, Judges.

LITTLETON, Judge.

Plaintiff sues to recover $10,093.11 income tax plus certain interest, alleged to have been overpaid for 1938 and 1939 by reason of the failure of the defendant to allow deductions for certain nontrade and nonbusiness expenses which were not allowable at the time plaintiff's returns were audited but which plaintiff claims are allowable now by reason of [§212]. The defense is not only on the merits but also on the ground of a settlement agreement entered into by the parties at the time deficiencies were determined for the two years.

Plaintiff filed returns for 1938 and 1939 which disclosed net income in the respective amounts of $40,509.41 and $87,245.93, and tax liability in the respective amounts of $6,050.36 and $24,103.08. In the return for 1938 plaintiff claimed deductions of $12,959.39 for hurricane loss to landscaped trees, $19,444.10 for insurance premiums paid, and $3,000 for legal fees paid; and in the return for 1939 claimed deductions of $4,552.62 for legal fees paid. After an examination by a revenue agent substantially all of the deductions mentioned were recommended for disallowance with a resulting deficiency for each year. Plaintiff protested the proposed disallowance and thereafter conferences were held with plaintiff's representatives. A further investigation was made by a revenue agent. As a result of these discussions, the representatives of the Commissioner agreed to recommend for allowance a deduction in the amount of $8,000 for the hurricane loss in lieu of the $12,959.39 claimed by plaintiff. Plaintiff abandoned his contention that the other deductions claimed were allowable. The Commissioner's representatives also agreed to make an adjustment in plaintiff's favor on account of certain dividends.* The result reached by the parties was an agreed net income for 1938 of $67,655.02 and for 1939 of $91,297.16.

Shortly thereafter, plaintiff's tax liability was recomputed for 1938 and 1939 on the income agreed to, showing deficiencies for each year. On May 5, 1941, the Commissioner's representative advised plaintiff that "your [plaintiff's] proposal for settlement" of the tax liability on the basis agreed upon had been accepted and enclosed a document, set out in finding 6,† which provided for a waiver of the statutory restrictions on the assessment and collection of the tax and also provided inter alia that upon execution by plaintiff and approval by the Commissioner

> the case shall not be reopened nor shall any claim for refund be filed or prosecuted respecting the taxes for the years above stated [1938 and 1939], in the absence of fraud,

* These adjustments apparently amounted to about $250 for 1938 and about $500 for 1939. — ED.

† The document was substantially the same as the current Form 870-AD (supra p. 910), except that the taxpayer also agreed "upon request of the Commissioner to execute at any time a final closing agreement as to the tax liability, on the foregoing basis, for said year(s) upon [under?] the provisions of [§7121]." — ED.

malfeasance, concealment or misrepresentation of material fact, or of an important mistake in mathematical calculations.

Plaintiff signed the formal agreement May 6, 1941, and it was formally accepted on behalf of the Commissioner on the same day (findings 7 and 8). The deficiencies agreed upon were paid by plaintiff on June 2, 1941.

On November 19, 1942,* after the enactment of the Revenue Act of 1942, which contained in Section 121 thereof provisions for the allowance of certain nonbusiness expenses as deductions [1954 Code, §212] and made such provisions retroactive for the years 1938 and 1939, plaintiff filed claims for refund for those years (findings 10 and 11), claiming that substantially the same deductions, except in the case of the hurricane loss, which had been disallowed by the Commissioner, should now be allowed. On December 29, 1943, the claims were disallowed by the Commissioner on the ground that the execution by plaintiff of the document, set out in finding 6, and its acceptance by the Commissioner precluded the allowance of the claims for refund (finding 12). This suit followed.

While the defendant is now contesting the allowance sought both on the ground of the deductibility of the items in question under [§212], and on the finality of the agreement executed by the parties, we find it unnecessary to consider the first defense since we are of the opinion that plaintiff is precluded under the second defense from maintaining suit on these claims. At the time this agreement was made and executed there was a substantial controversy between plaintiff and the Commissioner as to the former's correct tax liability for 1938 and 1939. Prior to the time the document was executed, the Commissioner had disallowed not only the items involved in this suit but also another substantial item. After protest by plaintiff and conferences both in Washington and New York City, and after at least two investigations had been made by a revenue agent, the parties reached an agreement as to plaintiff's correct net income under the law as it then existed. Whether the agreement was reached as a result of a compromise, or as a result of concessions by both parties, is not important. The conclusion is inescapable from the evidence that there was a meeting of minds as to the final disposition of the case. When that occurred, the Commissioner recomputed plaintiff's tax liability and transmitted to plaintiff the settlement document wherein was set out a deficiency for each of the years. In transmitting that document to plaintiff at that time, the Commissioner stated that he was accepting plaintiff's "proposal for settlement," and also referred to the document as an "agreement" when executed by plaintiff and approved on his behalf. In returning the document after execution, plaintiff likewise referred to it as an "agreement." See finding 7.

We are convinced from the facts that the document which plaintiff executed and the Commissioner accepted was not a mere waiver of restrictions on assessment and collection of a deficiency of tax on usual Form 870, as plaintiff seems to urge. That form was used as a starting point but important additions and alterations were made in it to incorporate the full terms of the agreement.† This was done "as a basis for closing the case." By that agreement the parties did much more than agree on the amount of plaintiff's tax liability, as is shown by the two paragraphs which were added to the stated form which they used as a vehicle to set up their agreement finally closing the case.

In language which we think is too clear to be misunderstood and which would be rendered meaningless if plaintiff's interpretation were to prevail, the agreement states:

* See §6511(a) for the period of limitations on the filing of a claim for refund. — Ed.

† The changes in effect converted Form 870 into Form 870-TS. — Ed.

If this proposal is accepted by or on behalf of the Commissioner, the case shall not be reopened nor shall any claim for refund be filed or prosecuted respecting the taxes for the years above stated, in the absence of fraud, malfeasance, concealment or misrepresentation of material fact, or of an important mistake in mathematical calculations.

There is no contention that there was any fraud, malfeasance, concealment, misrepresentation, or mistake in calculation. How this could be interpreted other than to preclude plaintiff from filing a claim for refund or prosecuting this suit is difficult to understand.

Plaintiff says, however, that the agreement is lacking in mutuality for the reason that the Commissioner was left free to reopen the case and assess further deficiencies. We do not so interpret the document. It is true, as will be noted from the document set out in finding 6, that on the prescribed Form 870 there was a provision which expressly stated that the execution of the agreement "does not . . . preclude the assertion of a further deficiency in the manner provided by law should it subsequently be determined that additional tax is due," but when the parties prepared and executed the agreement here involved that provision was stricken. A reasonable interpretation of the entire document is that what the parties sought to do was to close the case in such a manner that it could not be reopened either for a refund or for the assessment of deficiencies except in the case of fraud, malfeasance, etc. We see no reason for interpreting the document otherwise. That a closing agreement under [§7121] might have been entered into is not conclusive on the question whether the results which the parties desired to accomplish could not as well have been accomplished through the agreement which they here executed.

The case of Botany Worsted Mills v. United States, 278 U.S. 282, upon which plaintiff relies, involved an agreement of settlement which the Court held did not preclude the reopening of the case upon a claim for refund.* However, that case is easily distinguishable from the case at bar. In the *Botany Worsted* case the agreement was informal and oral in character and was agreed to only by subordinate officials in the Internal Revenue Bureau. There was no formal approval by or for the Commissioner. Many of the elements in the formal agreement involved in this case were lacking in that case. Moreover, we do not understand that case to hold, as plaintiff contends, that under no circumstances will a closing agreement be held binding unless executed in accordance with [§7121]. In discussing the finality of such agreements the Court said:

And, without determining whether such an agreement, though not binding in itself, may when executed become, *under some circumstances,* binding on the parties by estoppel, it suffices to say that here the findings disclose no adequate ground for any claim of estoppel by the United States. [Emphasis supplied.]

At the time the agreement in this case was executed the statute had not run on the collection of further deficiencies, but when the claims for refund were filed the statute had run. It would obviously be inequitable to allow the plaintiff to renounce the agreement when the Commissioner cannot be placed in the same

* In the *Botany Worsted Mills* case, the Supreme Court said that the existence of a statutory procedure for compromising tax liability (now §7122) precluded an alternative method of attaining finality. (The statutory provision for closing agreements, now §7121, was not enacted until several years after the years involved in the *Botany Mills* case.) The statute on compromises at that time required action by the Commissioner of Internal Revenue, with the advice and consent of the Secretary of the Treasury, and an opinion by the Solicitor of Internal Revenue; this formality, said the Court, demonstrated that Congress "did not intend to intrust the final settlement of such matters to the informal action of subordinate officials in the Bureau." Finding that the agreement was not binding on the government, the Court held that the taxpayer was also free to repudiate it. — Ed.

position he was when the agreement was executed. A clear case for the application of the doctrine of equitable estoppel exists and should be applied. . . .

Some support for plaintiff's position is found in Joyce v. Gentsch, 6 Cir., 141 F.2d 891, 895, where a similar Form 870 was involved and plaintiff was allowed to reopen the case. However, in that case the portion stricken from the form in this case was not stricken, and the Court in its opinion stated: "The right to assess a further deficiency was expressly reserved."

In Ross v. United States, Ct. Cl., 75 F. Supp. 725, we held that where a taxpayer files a petition with the Tax Court and a judgment thereon becomes final, he cannot thereafter file a claim for refund and obtain the benefit of the retroactive statute with which we are concerned even though the statute has not run on the filing of a claim for refund. In this case instead of filing a petition with the Tax Court, plaintiff waived his right to go to the Tax Court, consented to the assessment of the deficiencies, and in effect entered into an agreement which effected a finality similar to that which would have obtained had he gone to the Tax Court. . . .

Plaintiff is not entitled to recover and the petition is dismissed. It is so ordered.

HOWELL, MADDEN, and WHITAKER, Judges, and JONES, Chief Justice, concur.

NOTE

1. *Form 870 and estoppel.* What was the basis for the "equitable estoppel" that, in the opinion of the court, distinguished this case from the *Botany Worsted Mills* case? If the hurricane loss should have been totally disallowed, was it too late for the Commissioner to use this item as an offset in the refund action? If setting off the hurricane loss against the §212 deductions led to a net deficiency, could it be collected by the government? See page 906 supra.

See Daughette v. Patterson, 250 F.2d 753 (5th Cir. 1957), cert. denied, 356 U.S. 902, also holding a Form 870-TS binding on the ground of equitable estoppel. For another view of the estoppel argument, see Davis v. Commissioner, 29 T.C. 878 (1958):

> Among the elements necessary to the establishment of estoppel is a misrepresentation of fact on the part of the person sought to be estopped, a justified reliance upon that misrepresentation by the person to whom it is made, and a detriment sustained by the latter. We doubt that petitioner's undertaking in a document similar to Form 870-TS not to file or prosecute claims for refund, which was not legally binding on him and was known by respondent not to be an enforceable obligation, could be considered as a misrepresentation of fact upon which respondent could justifiably rely or did rely. We pass these elements, however, and address ourselves to the element of detriment on the part of respondent.
>
> The detriment shown in this proceeding is merely the running of the statute of limitations with regard to possible additional deficiencies relating to the years 1944 and 1945. We are not informed as to what those deficiencies, if any, might have been. It is true that some concessions were made by respondent in arriving at the agreed deficiencies set forth in the Form 870-TS, but we may not assume that they were made improvidently or without full legal and factual justification. No indication is given that any recoupments with regard to the claims for overpayment are urged by respondent, although . . . we have jurisdiction over . . . claims of recoupment even though relating to matters barred, so far as a determination of deficiency is concerned, by the statute of limitations.

Even if there is no affirmative showing of detriment to the Commissioner from a repudiation of a Form 870-AD, is there any reason of policy why an agreement that on its face binds both parties "in the absence of fraud, malfeasance, concealment or misrepresentation of material fact, or of an important mistake in mathematical calculations" should not do just that? If the taxpayer is free to repudiate the agreement, he obtains the tactical advantage of protection against an additional assessment (because of the Serv-

ice's policy not to renounce except for fraud, malfeasance, misrepresentation, or important mathematical error), while he awaits (for example) the outcome of other litigation, the discovery of favorable evidence, or the death of hostile witnesses before deciding whether to drop the matter or reopen it.

2. *Form 870 and closing agreements.* A closing agreement is binding "except upon a showing of fraud or malfeasance, or misrepresentation of a material fact." §7121. There is no express statutory ground for setting aside a compromise, §7122, though no doubt the same facts that would nullify a closing agreement would also nullify a compromise. A Form 870-AD agreement, however, by its own terms, can be set aside not only for fraud, malfeasance, or misrepresentation, but also for concealment or mathematical error. Does this mean that it is *not* an attempt to obtain the effect of a closing agreement or compromise without the formality prescribed by statute?

Under the 1939 Code, a closing agreement was effective only upon approval by the Secretary of the Treasury, the Under Secretary, or an Assistant Secretary; and a compromise required not only the approval of one of these exalted officials but also an opinion of the General Counsel of the Treasury. But the 1954 Code permits the Secretary to delegate his authority to enter into closing agreements and compromises, allows the General Counsel of the Treasury to delegate his power to file an opinion in compromise cases, and dispenses with the requirement of an opinion if the tax assessment to be compromised is less than $500. Should these changes lead to a reconsideration of the relation of the *Botany Worsted Mills* case to the enforceability of Form 870-AD? See Hamilton v. United States, 324 F.2d 960 (Ct. Cl. 1963) (Form 870-AD treated as binding compromise).

3. *Joyce v. Gentsch.* Joyce v. Gentsch, cited in the *Guggenheim* case, held that the taxpayer was not bound by a hybrid form: Form 870 was altered to forbid a claim for refund, but the clause stating that execution of the form does not "preclude the assertion of a further deficiency" was not stricken. Because the right to assert a further deficiency was reserved, the court said: "The waiver agreement was, therefore, entirely lacking in essential mutuality." Does it follow that because the Commissioner may assert a further deficiency (either because of such a reservation or because the agreement is not executed as a closing agreement or a compromise must be) the taxpayer is free to sue for a refund? Is there any reason why he may not waive his right to sue for a refund?

4. *Effect of Form 870 on running of interest on deficiencies.* In United States v. Goldstein, 189 F.2d 752 (1st Cir. 1951), it was held that whereas Form 870 stops the running of interest 30 days after it is executed by the taxpayer, Form 870-AD does not do so until 30 days after it has been acted on by the Commissioner. (In that case, about 15 months passed before such action was taken.) The court argued that Form 870-AD is by its terms an "offer" by the taxpayer, which does not become a "waiver" until action by the Commissioner, whereas Form 870 is itself a "waiver." Section 6601(d) provides that interest shall terminate 30 days after a "waiver." The court said that if the taxpayer wanted to protect himself against the Commissioner's leisurely manner he could have filed Form 870. Does the taxpayer have the right to file a Form 870 on his own motion whenever he believes that he has underpaid his tax, whether or not the Commissioner has raised the issue or asked for a waiver? See §6213(d).

5. *Other aspects of Form 870.* See also Steiner v. Nelson, 259 F.2d 853 (7th Cir. 1958) (form with typewritten addition requiring "acceptance" by Commissioner held ineffective in absence of acceptance); Holbrook v. United States, 284 F.2d 747 (9th Cir. 1960) (form effective without acceptance by Commissioner); Quigley v. Internal Revenue Service, 289 F.2d 878 (D.C. Cir. 1960) (form is a contract that can be set aside on grounds that permit other contracts between citizen and government to be set aside; no such grounds shown here); Blansett v. United States, 181 F. Supp. 637 (W.D. Mo. 1959) (form revocable until Commissioner makes assessment), rev'd on other grounds, 283 F.2d 474 (8th Cir. 1960).

6. *References.* Ohl, Implications of Form 870 and Related Tax "Settlements," 11 U. of Pitt. L. Rev. 173 (1950); Emmanuel, The Effect of Waivers in Federal Income Tax Cases, 3 U. of Fla. L. Rev. 176 (1950); Gutkin, Informal Federal Tax Settlements and Their Binding Effect, 4 Tax L. Rev. 477 (1949); Griswold, Finality of Administrative Settlements in Tax Cases, 57 Harv. L. Rev. 912 (1944).

e. TAXPAYERS' RULINGS

The Internal Revenue Service's policy regarding the issuance of rulings is described in Rev. Proc. 62-28, 1962-2 C.B. 496. The title "ruling" is given to a written statement, issued by the national office of the Internal Revenue Service in response to a taxpayer's inquiry, "which interprets and applies the tax laws to a specific set of facts." A "determination letter" is a similar statement by a District Director, in which "principles and precedents previously announced by the National Office" are applied to the particular facts. Rev. Proc. 62-28 goes on to allocate jurisdiction between the national and district offices, providing in general that the national office has exclusive jurisdiction over prospective transactions, novel issues, requests by trade associations and similar groups, industry-wide problems, and certain other matters.

In Rev. Proc. 62-32, 1962-2 C.B. 527, the Service repeated its long-standing refusal to issue rulings and determination letters on purely factual matters in advance of the filing of a return, and amplified this policy by listing the areas in which it will not issue advance rulings and those in which it will not "ordinarily" do so. The "no-ruling" areas include, among many others: whether an amount paid by an employer to an employee is a gift or compensation; whether meals and lodging are furnished for the employer's convenience; whether compensation paid is reasonable in amount within the meaning of §162; and whether the purpose in acquiring a corporation is evasion or avoidance of federal income taxes under §269. Areas in which rulings are possible, but not ordinarily granted, include: useful lives of depreciable assets; the market value of property; whether a corporation is "collapsible"; and whether real estate is held for investment or for sale to customers.

On the critical problem of the effect of a ruling, Rev. Rul. 62-28 states that a ruling (unless incorporated in a closing agreement) may be revoked or modified "at any time in the wise administration of the taxing statutes" and that such a change applies to all open years except to the extent that the Commissioner exercises his discretion under §7805(b) to limit its retroactive effect. The principles governing this exercise of discretion under §7805(b) are set out in Rev. Rul. 62-28, and include the following:

> Except in rare or unusual circumstances, the revocation or modification of a ruling will not be applied retroactively with respect to the taxpayer to whom the ruling was originally issued or to a taxpayer whose tax liability was directly involved in such ruling if (1) there has been no misstatement or omission of material facts, (2) the facts subsequently developed are not materially different from the facts on which the ruling was based, (3) there has been no change in the applicable law, (4) the ruling was originally issued with respect to a prospective or proposed transaction, and (5) the taxpayer directly involved in the ruling acted in good faith in reliance upon the ruling and the retroactive revocation would be to his detriment. To illustrate, the tax liability of each employee covered by a ruling relating to a pension plan of an employer is directly involved in such ruling. Also, the tax liability of each shareholder is directly involved in a ruling related to the reorganization of a corporation. However, the tax liability of members of an industry is not directly involved in a ruling issued to one of the members, and the position taken in a revocation or modification of a ruling to one member of an industry may be retroactively applied to other members of that industry. By the same reasoning, a tax practitioner may not obtain the nonretroactive application to one client of a modification or revocation of a ruling previously issued to another client. . . .
>
> With respect to Revenue Rulings published in the Internal Revenue Bulletin, taxpayers generally may rely upon such rulings in determining the rule applicable to their own transactions and need not request a specific ruling applying the principles of a pub-

lished Revenue Ruling to the facts of their particular cases where otherwise applicable. However, see . . . below. Revenue Rulings published in the Internal Revenue Bulletin ordinarily are not revoked or modified retroactively.

Since each Revenue Ruling represents the conclusion of the Service as to the application of the law to the entire state of facts involved, taxpayers, Service personnel, and others concerned are cautioned against reaching the same conclusion in other cases unless the facts and circumstances are substantially the same. Furthermore, they should consider the effect of subsequent legislation, regulations, court decisions, and Revenue Rulings.*

The effect of a determination letter is similar to that of a ruling, but only as to the taxpayer to whom it was issued. See Rev. Proc. 62-28, supra.

AUTOMOBILE CLUB OF MICHIGAN v. COMMISSIONER
353 U.S. 180 (1957)

MR. JUSTICE BRENNAN delivered the opinion of the Court.

In 1945, the Commissioner of Internal Revenue revoked his 1934 and 1938 rulings exempting the petitioner from federal income taxes, and retroactively applied the revocation to 1943 and 1944. . . . The Tax Court sustained the Commissioner's determinations, and the Court of Appeals for the Sixth Circuit affirmed. This Court granted certiorari.

The Commissioner had determined in 1934 that the petitioner was a "club" entitled to exemption under provisions of the internal revenue laws corresponding to [§501(c)(7)], notifying the petitioner that ". . . future returns, under the provisions of [§501(c)(7)] . . . will not be required so long as there is no change in your organization, your purposes or methods of doing business."† In 1938, the Commissioner confirmed this ruling in a letter stating: ". . . as it appears that there has been no change in your form of organization or activities which would affect your status the previous ruling of the Bureau holding you to be exempt from filing returns of income is affirmed. . . ." Accordingly the petitioner did not pay federal taxes from 1933 to 1945. The Commissioner revoked these rulings in 1945, however, and directed the petitioner to file returns for 1943 and subsequent years. Pursuant to this direction, the petitioner filed, under protest, corporate income and excess profits tax returns for 1943, 1944 and 1945.

The Commissioner's earlier rulings were grounded upon an erroneous interpretation of the term "club" in [§501(c)(7)] and thus were based upon a mistake of law. It is conceded that in 1943 and 1944 petitioner was not, in fact or in law, a "club" entitled to exemption within the meaning of [§501(c)(7)], and also that petitioner is subject to taxation for 1945 and subsequent years. It is nevertheless contended that the Commissioner had no power to apply the revocation retroactively to 1943 and 1944, and that, in any event, the assessment of taxes against petitioner for 1943 and 1944 was barred by the statute of limitations.

The petitioner argues that, in light of the 1934 and 1938 rulings, the Commissioner was equitably estopped from applying the revocation retroactively. This argument is without merit. The doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law. The decision in Stockstrom v. Commissioner, 190 F.2d 283 (D.C. Cir. 1951), to the extent that it holds to the contrary, is disapproved.

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* A similar warning is to be found in the front of each Cumulative Bulletin. See, e.g., 1963-1 C.B. 3. For a different formulation, used in earlier years, see 1952-2 C.B. i. — ED.

† Before 1943, exempt organizations were not required to file returns. In 1943, a provision, which is now §6033, was enacted to require many exempt organizations to file annual information returns. — ED.

Petitioner's reliance on H.S.D. Co. v. Kavanagh, 191 F.2d 831, and Woodworth v. Kales, 26 F.2d 178, is misplaced because those cases did not involve correction of an erroneous ruling of law. Reliance on Lesavoy Foundation v. Commissioner, 238 F.2d 589, is also misplaced because there the court recognized the power in the Commissioner to correct a mistake of law, but held that in the circumstances of the case the Commissioner had exceeded the bounds of the discretion vested in him under [§7805(b)].

The Commissioner's action may not be disturbed unless, in the circumstances of this case, the Commissioner abused the discretion vested in him by [§7805(b)]. That section provides:

> *Retroactivity of Regulations or Rulings.* — The Secretary or his delegate may prescribe the extent, if any, to which any ruling or regulation relating to the internal revenue laws, shall be applied without retroactive effect.

The petitioner contends that this section forbids the Commissioner taking retroactive action. On the contrary, it is clear from the language of the section and its legislative history that Congress thereby confirmed the authority of the Commissioner to correct any ruling, regulation or Treasury decision retroactively, but empowered him, in his discretion, to limit retroactive application to the extent necessary to avoid inequitable results.

The petitioner, citing Helvering v. Reynolds Co., 306 U.S. 110, argues that resort by the Commissioner to [§7805(b)] was precluded in this case because the repeated re-enactments of [§501(c)(7)] gave the force of law to the provision of the Treasury regulations relating to that section. These regulations provided that when an organization had established its right to exemption it need not thereafter make a return of income or any further showing with respect to its status unless it changed the character of its operations or the purpose for which it was originally created. Helvering v. Reynolds Co. is inapplicable to this case. As stated by the Tax Court: "The regulations involved there [Helvering v. Reynolds Co.] . . . purported to determine what did or did not constitute gain or loss. The regulations here . . . in nowise purported to determine whether any organization was or was not exempt." These regulations did not provide the exemption or interpret [§501(c)(7)], but merely specified the necessary information required to be filed in order that the Commissioner might rule whether or not the taxpayer was entitled to exemption. This is thus not a case of ". . . administrative construction embodied in the regulation[s] . . ." which, by repeated re-enactment of [§501(c)(7)], ". . . Congress must be taken to have approved . . . and thereby to have given . . . the force of law." Helvering v. Reynolds Co., 306 U.S., at 114, 115.

We must, then, determine whether the retroactive action of the Commissioner was an abuse of discretion in the circumstances of this case. The action was the consequence of the reconsideration by the Commissioner, in 1943, of the correctness of the prior rulings exempting automobile clubs, initiated by [G.C.M. 23688, 1943 C.B. 283], interpreting [§501(c)(7)] to be inapplicable to such organizations. The Commissioner adopted the General Counsel's interpretation and proceeded to apply it, effective from 1943, indiscriminately to automobile clubs. We thus find no basis for disagreeing with the conclusion, reached by both the Tax Court and the Court of Appeals, that the Commissioner, having dealt with petitioner upon the same basis as other automobile clubs, did not abuse his discretion. Nor did the two-year delay in proceeding with the petitioner's case, in these circumstances, vitiate the Commissioner's action. . . .

[The Court also held that the statute of limitations did not run for 1943 and 1944 because the taxpayer failed to file income tax returns for those years, the

failure not being excused by the 1934 and 1938 rulings because "no action of the Commissioner can change or modify the conditions under which the United States consents to the running of the statute of limitations against it." The Court also held that information returns filed by the taxpayer for 1943 and 1944 under §6033 were not a satisfactory substitute for tax returns, so far as the statute of limitations is concerned. The Court's discussion of the final issue in the case, the proper method of accounting for membership dues paid in advance, is summarized supra page 795.]

Affirmed.

[Mr. Justice Burton and Mr. Justice Clark joined in the Court's opinion as to the revocation of the rulings and the statute of limitations question. Mr. Justice Harlan dissented on the statute of limitations question.]

NOTE

1. *Revocability of rulings.* The revocability of a ruling was litigated as early as 1928, in Couzens v. Commissioner, 11 B.T.A. 1040 (1928). This case concerned a group of minority shareholders of the Ford Motor Company, who were negotiating with Henry Ford, Sr., for a sale of their shares. They requested the Internal Revenue Service to rule on the March 1, 1913, value of their stock, which would be controlling (§1053) in determining their gain. (As indicated supra page 916, the Service usually will not rule on questions of value.) In 1919, after an extended investigation, the Service ruled that the 1913 value was $9500 per share, and the taxpayer sold his shares thereafter, reporting a profit of about $8.6 million. The Service later determined that the 1913 value of the stock was only $2634 per share, which increased the taxable profit to about $20.7 million, and assessed a deficiency on this basis. Part of the assessment was later abated, when the Service raised its determination of 1913 value to $3500 per share, and the taxpayer contested the balance of the assessment. The Tax Court held that the government was not bound by the 1919 ruling and made an independent determination of the stock's 1913 value. Ironically, it set a value of $10,000 per share, which was more favorable to the taxpayer than the Service's 1919 ruling. In a suit by another taxpayer involving the same ruling, the Commissioner was held to be bound by the ruling, or at least by an assessment made pursuant to it. Woodworth v. Kales, 26 F.2d 178 (6th Cir. 1928). Having obtained a refund on the theory that the government was bound by the ruling, however, the taxpayer brought a second suit to recover part of the tax originally paid pursuant to the ruling on the ground that the ruling was too favorable to the government. This suit was also successful. United States v. Kales, 314 U.S. 186 (1941). (The Court held that the judgment in the first suit, against the Collector of Internal Revenue, was not res adjudicata in a suit against the United States, see page 938 infra.) See also H.S.D. Co. v. Kavanagh, 191 F.2d 831 (6th Cir. 1951), holding that the Commissioner could not revoke a ruling that a pension trust was exempt from taxation, where the ruling was based on full knowledge of all the facts. Does the Supreme Court in the *Michigan Auto Club* case endorse the *Woodworth* and *H.S.D.* cases?

The *Lesavoy Foundation* case, distinguished by the Supreme Court in the *Michigan Auto Club* case, concerned the Commissioner's retroactive revocation of a certificate of tax exemption on the ground that the taxpayer had departed from its exempt purpose and was operating in the interest of the donor's business enterprises. The court found that the taxpayer had made a sufficient disclosure of the facts to the Commissioner before the certificate was issued and held that the Commissioner abused his discretion under §7805(b) in failing to make the revocation of the certificate nonretroactive. The court distinguished between rulings "of general application" and "individualized taxpayer's rulings," asserting that the former can be revoked retroactively, but apparently holding that the latter can be revoked only if the taxpayer is estopped "from relying on the ruling in good faith because he has concealed the facts, or because of some other fraud or misrepresentation." But the taxpayer's "reliance" on the ruling in *Lesavoy* seems similar to the taxpayer's action in the *Michigan Auto* case.

In Goodstein v. Commissioner, 267 F.2d 127 (1st Cir. 1959), the court held that *Lesavoy*

Foundation case was not applicable to a taxpayer who relied on an unpublished ruling issued to another taxpayer, at least when it was in conflict with the only published ruling in point. See also Knetsch v. United States, supra page 185 (last paragraph of majority opinion).

2. *Injury caused by erroneous ruling.* Does the Federal Tort Claims Act permit a taxpayer who has been damaged by an erroneous ruling or bad advice from the Internal Revenue Service to recover from the United States? See United States Code, Title 28, §1346(b) (sovereign immunity waived for injury or loss of property "caused by the negligent or wrongful act or omission of any employee of the Government while acting within the scope of his office or employment, under circumstances where the United States, if a private person, would be liable to the claimant in accordance with the law of the place where the act or omission occurred"), §2680(b) (no liability for exercise of discretionary function, even if discretion is abused), and §2680(c) (no liability for any claim "arising in respect of the assessment or collection of any tax"). See also Bershad v. Wood, 290 F.2d 71 (9th Cir. 1961) (District Director and staff not liable for wrongful acts in enforcing tax liens).

3. *Business transactions conditioned on favorable rulings.* The extent to which a ruling can ordinarily be relied on is attested by the frequency with which corporate agreements for sales of assets, liquidations, or reorganizations are conditioned on a favorable ruling by the Internal Revenue Service. The following terms of a contract for the sale of assets and liquidation of one of the contracting parties, specifying certain rulings as a prerequisite to performance by either party, are somewhat elaborate, but not atypical:

> 6.1 *Drilexco Tax Rulings.* Promptly after the date hereof, Drilexco shall make application for a ruling or rulings from the Internal Revenue Service substantially to the effect that (i) for purposes of Section 337 of the Internal Revenue Code, the date of adoption of the Plan will be the date on which the shareholders of Drilexco approve resolutions adopting the Plan; (ii) for federal income tax purposes no gain or loss will be recognized to Drilexco upon the receipt by Drilexco of the Purchase Price from the sale of the assets, properties and rights sold to Sinclair, other than assets excluded from the term "property" by Section 337(b) of the Internal Revenue Code, or upon the receipt by Drilexco of the proceeds from the sale of the Drilexco Production Payment, or upon the receipt by Drilexco of the proceeds of the sale of stock and assets under the Drilling Subsidiaries Agreement, provided that within the twelve-month period beginning on the date of the adoption of the Plan Drilexco shall have distributed to its shareholders all assets of Drilexco less assets reasonably retained to meet claims (including unascertained or contingent liabilities) and specifically set aside for that purpose; (iii) no gain or loss will be recognized to Drilexco upon the receipt of assets of certain Drilling Subsidiaries on account of their liquidation; (iv) amounts distributed to the shareholders of Drilexco in complete liquidation of Drilexco will be treated as in full payment for their stock under Section 331(a)(1) of the Internal Revenue Code; and (v) provided the stock of Drilexco is a capital asset in the hands of the shareholders, gain or loss will be recognized to said shareholders under Sections 1001 and 1002 of the Internal Revenue Code and such gain or loss will constitute capital gain or loss subject to the provisions and limitations of Chapter 1, Subchapter P of the Internal Revenue Code.
>
> 6.2 *First Ridge Tax Rulings.* Promptly after the date hereof First Ridge shall make application for a ruling or rulings from the Internal Revenue Service substantially to the effect that (i) the Drilexco Production Payment will be a depletable economic interest in oil, gas and other hydrocarbons in the hands of First Ridge; (ii) the proceeds received from the sale of the production attributable to the Drilexco Production Payment will be includible in the gross income of First Ridge, subject to the depletion allowance; (iii) in computing taxable income, First Ridge will be entitled to a deduction for cost depletion measured by its basis in the Drilexco Production Payment, being the amount to be paid by it therefor plus its costs incident to the acquisition; (iv) the amount of production and ad valorem taxes and other similar taxes, to the extent applicable to the Drilexco Production Payment, will be includible in the gross income of First Ridge; and (v) the taxes referred to as being

includible in the gross income of First Ridge as owner of the Drilexco Production Payment will be deductible by it in computing its taxable income.

6.3 *Provisions Applicable to Tax Ruling Applications.* Copies of the applications for tax rulings to be filed by the parties hereto shall be exchanged sufficiently in advance of filing to afford a reasonable opportunity for review and comment. The filing party in each case agrees (i) to use its best efforts to obtain a favorable ruling pursuant to its application, (ii) to keep the other party fully advised with respect to the progress thereof, and (iii) to furnish the other party copies of all communications to and from the Internal Revenue Service in connection therewith. Upon receipt of a tax ruling by a party, such party will (within three business days thereafter) forward a photostatic copy of same to the other party hereto. The transmittal of such ruling shall include a statement by the transmitting party whether such ruling is favorable and satisfies the ruling condition of this Section 6. In connection with this paragraph, it is agreed that a provision in a ruling obtained by Drilexco that (u) the applicability of Section 337 of the Internal Revenue Code is dependent on the inapplicability of the provisions of Section 337(c) of the Internal Revenue Code, (v) Drilexco must report the income from the properties up to Closing Date and pay income taxes thereon, (w) the ruling is inapplicable to items of the nature described in Revenue Ruling 61-214, Cumulative Bulletin 1961-2, 60, from which Drilexco derived full tax benefits through deductions in prior years, and that the portion of the proceeds allocable to such items, if any, will be treated as ordinary income, (x) the depreciation deduction for the taxable year of disposition of a depreciable asset is limited to the amount, if any, by which the adjusted basis of the asset at the beginning of the year exceeds the amount realized by Drilexco upon the sale or exchange of such asset (Revenue Ruling 62-92, C.B. 1962-1, 29), (y) the gain, if any, on the sale or distribution of depreciable personal property will be recognized to the extent provided in Section 1245 of the Internal Revenue Code or (z) no deduction is allowable to Drilexco under Section 265 of the Internal Revenue Code for state income taxes, expenses and interest allocable to gains not recognized under Section 337(a) (Revenue Ruling 60-236, C.B. 1960-2, 109), shall not prevent the ruling from being deemed a favorable and acceptable ruling hereunder. Neither Drilexco nor First Ridge shall be obligated to consummate the transactions contemplated hereby if a ruling is found to be unfavorable to it by its Tax Counsel referred to below.

By virtue of the above clause, the parties are not obligated to perform under the contract unless and until a favorable ruling is received. Sometimes a taxpayer is prepared to consummate a transaction subject to a divestment clause that will restore the status quo ante if a favorable ruling is not forthcoming by a specified date. In Rev. Rul. 59-309, 1959-2 C.B. 117, the Internal Revenue Service announced that it did not object to a provision in a newly established pension or profit-sharing plan requiring the employer's contribution to be returned in the event the Service ruled that the plan did not meet the "qualification" requirements of §401. In another ruling, however, the Service objected to a provision in a stock option plan fixing the price to be paid by employees for the stock at 95 per cent of the New York Stock Exchange quotation unless the Internal Revenue Service ruled that the quoted price was not its fair market value, in which event the price was to be 95 per cent of the value as determined by the Service: "The Commissioner need not comply with a provision which seeks to require the Treasury Department to assume the function of making determinations of fair market value for the purpose of fixing an option price, and since he could in no event make such a determination on the date of grant of an option, an agreement containing such a provision does not provide a price determinable at that time within the meaning of [Regs. §1.421-1(d)(2)]." Rev. Rul. 59-243, 1959-2 C.B. 123. In view of the Service's refusal to rule on the reasonableness of compensation, what would be the effect of an agreement by an employee to refund such part of his compensation as might be found to be unreasonable by the Internal Revenue Service or the courts? Note that declaratory judgments cannot be obtained in tax cases (infra p. 927); see also Commissioner v. Proctor, infra page 1012; Sugarman,

Drafting Clauses of Escape in Agreements with Uncertain Tax Consequences, 1960 So. Calif. Tax Inst. 131.

4. *Volume of rulings.* During the fiscal year 1962, the Internal Revenue Service "processed" about 26,000 requests for rulings and technical advice from taxpayers and about 1100 requests from its field offices in income and excess profits tax matters. The number of determination letters is not stated in the Commissioner's Annual Report for 1962, except as to employee benefit plans (about 10,000) and exempt organizations (about 6500).

5. *Publication of rulings.* Until 1953, it was the Service's practice to publish only a small selection of its rulings to taxpayers; a few more became public information because publicized by the taxpayers themselves or their advisers. In 1952, the report of the Subcommittee on Administration of the Internal Revenue Laws of the House Committee on Ways and Means (better known as the "King Committee") stated (p. 30):

> Much information supplied by taxpayers to the Bureau of Internal Revenue is kept confidential to avoid possible embarrassment or competitive disadvantage to the taxpayer. Consistent with this laudable policy, however, the Bureau should make public as many as possible of its administrative decisions. Their availability to public scrutiny should serve as a deterrent to favoritism and enable the public to satisfy itself as to the impartiality of tax administration. The Bureau recently opened to the public its offer-in-compromise files, and also the files of the Alcohol and Tobacco Tax Division relative to issuance of basic permits. At the instance of the subcommittee, the Bureau has adopted a new policy of publishing in permanent form all decisions and rulings involving points of law upon which the Bureau will thereafter rely as precedents.

The Service has announced that all rulings to taxpayers or their representatives and communications to its field offices involving "substantive tax law, procedures affecting taxpayers' rights or duties or industry regulation" "will be deemed to be of a character potentially publishable" (a pharase that seems to mean "will be published") with the following exceptions:

> (a) those involving questions specifically and clearly covered by statute or regulations;
>
> (b) those involving questions specifically covered by rulings, opinions, or court decisions previously published in the Bulletin;
>
> (c) those dealing with issues upon which court action is pending and publication would be prejudicial to the best interest of the Government;
>
> (d) those in which the facts involved are so unique or specific that the issue is not likely to arise again;
>
> (e) those which constitute determinations of fact rather than interpretations of law; . . .
>
> (h) those dealing with secret formulae or business practices;
>
> (i) those dealing with informers and informers' rewards; or
>
> (j) those which in the interest of a wise administration of the Revenue Service should not be published, but only if a memorandum stating the reasons therefor is attached to the file and the Commissioner approves the determination of nonpublication. [Rev. Rul. 2, 1953-1 C.B. 484; Rev. Rul. 212, 1953-2 C.B. 449.]

See also Rev. Proc. 55-1, 1955-2 C.B. 897, setting out a policy of publishing "internal practices and procedures" which "affect rights or duties of taxpayers."

This increase in published rulings makes more acute a problem already of significant proportions: since the Service has a policy of adhering to a ruling with respect to the taxpayer himself, should it not also be chary of revoking it as to other taxpayers who may have relied on it as much as the taxpayer who requested it? But the more solicitous the Service is of possible reliance on a ruling by other taxpayers, the more cautious it may be in issuing rulings; and since liberalizing the criteria for publication will increase the circle of taxpayers whose possible reliance the Service must take account of, there may be a decline in the use of this device for preventing or settling tax disputes.

In this connection, it might be noted that Rev. Rul. 2, supra, provides that the

Service's standards for determining what communications are to be referred to the Chief Counsel for review "will continue in effect," but that in applying these standards

> officials having responsibility for issuing such communications will give consideration to the added importance which may attach to such communication if published, especially with the view that rulings which may be cited as establishing legal principles should be so reviewed before issuance.

6. *References.* Caplin, Taxpayer Rulings Policy of the Internal Revenue Service: A Statement of Principles, 20 N.Y.U. Inst. on Fed. Taxation 1 (1962); Redman, New Procedures re Letter Rulings; Request for Washington Assistance, 1963 So. Calif. Tax Inst. 411; Taylor, Tax Rulings: New Rules and Procedures, 21 N.Y.U. Inst. on Fed. Taxation 69 (1963); Clark, Practical Considerations in Obtaining Rulings and in Filing Claims for Refund, 1957 Tulane Tax Inst. 257; Manning, The Application of the Doctrine of Estoppel Against the Government in Federal Tax Cases, 30 N.C.L. Rev. 356, 367-380 (1952); Newman, Should Official Advice Be Reliable? — Proposals as to Estoppel and Related Doctrines in Administrative Law, 53 Colum. L. Rev. 374 (1953).

Section B. Collection of the Tax

All but a small fraction of all taxes are paid voluntarily (not necessarily willingly) by the taxpayer. Even the taxpayer who disputes liability, if he does not go to the Tax Court, ordinarily pays when the tax is assessed (or before), suing thereafter for a refund. And most taxpayers who litigate in the Tax Court pay promptly if they lose.

But sometimes it is necessary for the government to compel payment, and when this occasion arises, it has a variety of weapons. The most drastic is distraint — seizure and sale of personal and real property, pursuant to §6331(a) and (b). See Bull v. United States, 295 U.S. 247, 260 (1935):

> A tax is an exaction by the sovereign, and necessarily the sovereign has an enforceable claim against every one within the taxable class for the amount lawfully due from him. The statute prescribes the rules of taxation. Some machinery must be provided for applying the rule to the facts in each taxpayer's case, in order to ascertain the amount due. The chosen instrumentality for the purpose is an administrative agency whose action is called an assessment. The assessment may be a valuation of property subject to taxation, which valuation is to be multiplied by the statutory rate to ascertain the amount of tax. Or it may include the calculation and fix the amount of tax payable, and assessments of federal estate and income taxes are of this type. Once the tax is assessed, the taxpayer will owe the sovereign the amount when the date fixed by law for payment arrives. Default in meeting the obligation calls for some procedure whereby payment can be enforced. The statute might remit the government to an action at law wherein the taxpayer could offer such defense as he had. A judgment against him might be collected by the levy of an execution. But taxes are the lifeblood of goverment, and their prompt and certain availability an imperious need. Time out of mind, therefore, the sovereign has resorted to more drastic means of collection. The assessment is given the force of a judgment, and if the amount assessed is not paid when due, administrative officials may seize the debtor's property to satisfy the debt.
>
> In recognition of the fact that erroneous determinations and assessments will inevitably occur, the statutes, in a spirit of fairness, invariably afford the taxpayer an opportunity at some stage to have mistakes rectified. Often an administrative hearing is afforded before the assessment becomes final; or administrative machinery is provided whereby an erroneous collection may be refunded; in some instances both administrative relief and redress by an action against the sovereign in one of its courts are permitted methods of restitution of excessive or illegal exaction. Thus, the usual procedure for the recovery of debts is reversed in the field of taxation. Payment precedes defense, and the burden of proof, normally on the claimant, is shifted to the taxpayer. The assess-

ment supersedes the pleading, proof, and judgment necessary in an action at law, and has the force of such a judgment. The ordinary defendant stands in judgment only after a hearing. The taxpayer often is afforded his hearing after judgment and after payment, and his only redress for unjust administrative action is the right to claim restitution.

For historical background, see Tresolini, Administrative Tax Enforcement: Legal Concepts, 27 Temp. L.Q. 8 (1953); United States v. Manufacturers Trust Co., 198 F.2d 366 (2d Cir. 1952); United States v. Metropolitan Life Ins. Co., 130 F.2d 149 (2d Cir. 1942). The federal statute has its own set of exemptions (clothing and school books "necessary" for the taxpayer and his family; up to $250 worth of tools needed in the taxpayer's occupation; and, if the taxpayer is head of a family, up to $500 worth of fuel, furniture, personal effects, livestock, "arms for personal use," etc.), and state exemptions are not binding. §6334(a); see Jones v. Kemp, 144 F.2d 478 (10th Cir. 1944).

In lieu of distraint, the government may proceed by suit, either in a federal district court (see 28 U.S.C. 1396 for venue) or in a state court. See Anderson, Federal Tax Suits in State Courts, 26 Taxes 1144 (1948), disputing the propriety of state court actions.

The government is also provided with a tax lien, which can be enforced as an alternative method of collecting the tax. §§6231 and 7403. The priority of federal tax claims and tax liens is a very troubled subject. See United States v. Gilbert Associates, Inc., 345 U.S. 361 (1953); Meyer v. United States, 375 U.S. 233 (1963); Kennedy, The Relative Priority of the Federal Government: The Pernicious Career of the Inchoate and General Lien, 63 Yale L.J. 905 (1954).

For a narrative account of the efforts of the government to collect unpaid income taxes in a particular case, illustrating the use of various methods of discovering and reaching assets, see Noell v. Commissioner, 22 T.C. 1035 (1954).

A comprehensive survey of this field may be found in Plumb, Federal Tax Collection and Lien Problems, 13 Tax L. Rev. 247 and 459 (1958); see also A.B.A., Final Report of Committee on Federal Liens (1959); Sarner, Federal Tax Liens, 21 N.Y.U. Inst. on Fed. Taxation 1431 (1963); Note, Federal Priorities and Tax Liens, 63 Colum. L. Rev. 1259 (1963).

1. *Injunctions Against Collection*

Section 7421 of the 1954 Code, relating to injunctions against assessment and collection of tax, is substantially the same as §3653 of the 1939 Code.

ENOCHS v. WILLIAMS PACKING CO.
370 U.S. 1 (1961)

MR. CHIEF JUSTICE WARREN delivered the opinion of the Court.

Fearing that the District Director of Internal Revenue for Mississippi would attempt to collect allegedly past due social security and unemployment taxes for the years 1953, 1954 and 1955, respondent, in late 1957, brought suit in the District Court, maintaining that it was not liable for the exactions and seeking an injunction prohibiting their collection. The District Director, petitioner herein, made no objection to the issuance of a preliminary restraining order but resisted a permanent injunction, asserting that the provisions of §7421(a) of the Internal Revenue Code of 1954 barred any such injunctive proceeding. That section provides:

Except as provided in sections 6212(a) and (c), and 6213(a), no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court.

The exception for Tax Court proceedings created by §§6212(a) and (c) and 6213 (a) was not applicable because that body is without jurisdiction over taxes of the sort here in issue. Nevertheless, on July 14, 1959, the court, relying upon Miller v. Standard Nut Margarine Co., 284 U.S. 498, permanently enjoined collection of the taxes on the ground that they were not, in fact, payable and because collection would destroy respondent's business. 176 F. Supp. 168. On June 14, 1961, the Court of Appeals for the Fifth Circuit affirmed, one judge dissenting. 291 F.2d 402. We granted certiorari to determine whether the case came within the scope of this Court's holding in *Nut Margarine* which indicated that §7421(a) was not, in the "special and extraordinary facts and circumstances" of that case, intended to apply. 368 U.S. 937.

Respondent corporation (hereinafter referred to as Williams) is engaged in the business of providing trawlers to fishermen who take shrimp, oysters and fish off the Louisiana and Mississippi coasts. It is the Government's position that these fishermen are the corporation's employees within the meaning of . . . §§3121 (d)(2) and 3306 (i) of the Internal Revenue Code of 1954. These sections specifically adopt the common-law test for ascertaining the existence of the employer-employee relationship. As stated in United States v. Silk, 331 U.S. 704, 716, "degrees of control, opportunities for profit or loss, investment in facilities, permanency of relation and skill required . . . are important for decision [under these statutes]." If, under the involved circumstances of this case, the fishermen were employees, respondent Williams is admittedly liable for social security and unemployment taxes for the years in question.

The following facts, material to the question of the existence of the employment relationship, were established. Williams provided its boats to captains which it selected; they employed their own crews and could fire them at will, but the relationship between respondent corporation and the fishermen was not ordinarily of short duration. The catch was generally sold to Williams which in turn resold it to the DeJean Packing Co., a partnership closely allied to Williams both by reason of integrated operation and substantially identical ownership. The proceeds, after the deduction of expenses, were divided among the captain, the crew and the boat. Williams received an additional share if it supplied the nets and rigging. It extended credit to the captains and made it possible for them to obtain credit elsewhere, and if a trip was unsuccessful and if the captain or crew members no longer continued to operate a boat, Williams absorbed the loss.

With respect to the existence of a recognized right of control by the employer, as might be expected, the testimony was in conflict. Petitioner introduced evidence to show that Williams could effectively refuse ice to boats and thus determine whether they would go out, that the boats' times of return were sometimes directed by the respondent corporation, that it could dictate the nature of the catch, and that permission was needed to sell the catch to someone other than respondent. And petitioner pointed out that both respondent and its fishermen had for other purposes represented that an employer-employee relationship existed. On the other hand, the District Court here found, and the respondent now asserts, that the corporation was wholly without any right of control.

Attempting to establish a basis for equitable jurisdiction, the corporation maintains that it will be thrown into bankruptcy if required to pay the entire assessment of $41,568.57. It is undisputed that Williams itself is without available

funds in this amount, but the Government suggests that respondent has denuded itself of assets in anticipation of its tax liability, that DeJean's assets should be considered as belonging to respondent, and that, in any event, the respondent corporation may pay the assessment for a single quarter and then sue for a refund.

The object of §7421(a) is to withdraw jurisdiction from the state and federal courts to entertain suits seeking injunctions prohibiting the collection of federal taxes. In Miller v. Standard Nut Margarine Co., supra, this Court was confronted with the question whether a manufacturer of "Southern Nut Product" could enjoin the collection of federal oleomargarine taxes on its goods. Prior to the assessment in issue three lower federal court cases had held that similar products were nontaxable and, by letter, the collector had informed the manufacturer that "Southern Nut Product" was not subject to the tax. This Court found that "[a] valid oleomargarine tax could by no legal possibility have been assessed against . . . [the manufacturer], and therefore the reasons underlying . . . [§7421(a)] apply, if at all, with little force." Noting that collection of the tax "would destroy its business, ruin it financially and inflict loss for which it would have no remedy at law," the Court held that an injunction could properly issue. Id., at 510-511. The courts below seem to have found that *Nut Margarine* decides that §7421(a) does not bar suit for an injunction against the collection of taxes not due if the legal remedy is inadequate. We cannot agree.

The enactment of the comparable Tax Injunction Act of 1937, 50 Stat. 738, now, as amended, 28 U.S.C. §1341, forbidding the federal courts to entertain suits to enjoin collection of state taxes "where a plain, speedy, and efficient remedy may be had at law or in equity in the courts of such State," throws light on the proper construction to be given §7421(a). It indicates that if Congress had desired to make the availability of the injunctive remedy against the collection of federal taxes not lawfully due depend upon the adequacy of the legal remedy, it would have said so explicitly. Its failure to do so shows that such a suit may not be entertained merely because collection would cause an irreparable injury, such as the ruination of the taxpayer's enterprise. This is not to say, of course, that inadequacy of the legal remedy need not be established if §7421(a) is inapplicable; indeed, the contrary rule is well established. See, e.g., Matthews v. Rodgers, 284 U.S. 521; Miller v. Standard Nut Margarine Co., supra; Dows v. Chicago, 11 Wall. 108. However, since we conclude that §7421(a) bars any suit for an injunction in this case, we need not determine whether the taxpayer would suffer irreparable injury if collection were effected.

The manifest purpose of §7421(a) is to permit the United States to assess and collect taxes alleged to be due without judicial intervention, and to require that the legal right to the disputed sums be determined in a suit for refund. In this manner the United States is assured of prompt collection of its lawful revenue. Nevertheless, if it is clear that under no circumstances could the Government ultimately prevail, the central purpose of the Act is inapplicable and, under the *Nut Margarine* case, the attempted collection may be enjoined if equity jurisdiction otherwise exists. In such a situation the exaction is merely in "the guise of a tax." Id., at 509.

We believe that the question of whether the Government has a chance of ultimately prevailing is to be determined on the basis of the information available to it at the time of suit. Only if it is then apparent that, under the most liberal view of the law and the facts, the United States cannot establish its claim, may the suit for an injunction be maintained. Otherwise, the District Court is without jurisdiction, and the complaint must be dismissed. To require more than good faith on the part of the Government would unduly interfere with a collat-

eral objective of the Act — protection of the collector from litigation pending a suit for refund. And to permit even the maintenance of a suit in which an injunction could issue only after the taxpayer's nonliability had been conclusively established might "in every practical sense operate to suspend collection of the . . . taxes until the litigation is ended." Great Lakes Dredge & Dock Co. v. Huffman, 319 U.S. 293, 299. Thus, in general, the Act prohibits suits for injunctions barring the collection of federal taxes when the collecting officers have made the assessment and claim that it is valid. Snyder v. Marks, 109 U.S. 189, 194.

The record before us clearly reveals that the Government's claim of liability was not without foundation. Therefore, we reverse the judgment of the Court of Appeals and remand the case to the District Court with directions to dismiss the complaint.

Reversed.

MR. JUSTICE FRANKFURTER took no part in the consideration or decision of this case.

NOTE

1. *Other cases applying §7421.* See also Farmer v. Rountree, 252 F.2d 490 (6th Cir. 1958), refusing to enjoin collection of two thirds of the taxpayer's income tax on the ground that this portion of appropriations is to carry out the military and foreign policy of the United States, allegedly in violation of international law; despite appellant's "extensive knowledge of the foreign relations and policies of the United States," the complaint concerns political issues confided to Congress and President, not to the courts. A similar result was reached in Mayer v. Wright, 251 F.2d 178 (9th Cir. 1958), where appellant objected to "payment of that part of his Federal income tax that is expended for past, present and possible future wars."

The cases under §7421(a) are collected in Communist Party, U.S.A. v. Moysey, 141 F. Supp. 332 (S.D.N.Y. 1956), refusing to enjoin collection of taxes under a jeopardy assessment, the complaint being based on political character of taxpayer, abuse of discretion, and denial of due process and equal protection.

In Campbell v. Guetersloh, 287 F.2d 878 (5th Cir. 1961), the court dissolved an injunction granted by the District Court to restrain use of the bank deposit method of computing taxable income, saying "[s]hort of specific violations of some statutory course of conduct . . . the Commissioner is free to make his investigation without instruction from the court as to what theory he is to use to reconstruct income of a taxpayer which his investigation leads him to believe has been incorrectly reported."

It has been held that §7421(a) does not deny the equitable remedy of injunction to a person whose property is threatened with seizure to pay someone else's tax. Thus the government can be restrained from seizing partnership property to pay the individual tax of one of the partners on the complaint of either partnership creditors or other partners. Adler v. Nicholas, 166 F.2d 674 (10th Cir. 1948); see also Shelton v. Gill, 202 F.2d 503 (4th Cir. 1953). Section 7421(b), however, forbids injunctions against assessment or collection in cases of transferee liability. Should equity intervene more freely where a transferee is involved than where the property of the taxpayer himself is about to be seized?

See Bershad v. Wood, 290 F.2d 714 (9th Cir. 1961) (government officials not personally liable for seizing property under mistaken apprehension it belonged to a taxpayer).

2. *Declaratory judgments in tax cases.* The Federal Declaratory Judgment Act was amended in 1935 to exclude federal tax controversies from its ambit. In Filipowicz v. Rothensies, 31 F. Supp. 716, 722 (E.D. Pa. 1940), the court said that this amendment "should be interpreted to deny a declaratory judgment to a petitioner only where the latter could not obtain an injunction" because of §7421(a), and added:

> In fact, such a rule would appear to be too restrictive inasmuch as there are cases where an equity court would refuse to grant an injunction because of the failure

to state the need for equitable relief, while such a prerequisite would not be necessary for a declaratory judgment.

For recent cases denying declaratory judgments, see Kyron Foundation v. Dunlap, 110 F. Supp. 428 (D.C. 1952), and Taylor v. Allan, 204 F.2d 485 (10th Cir. 1953); see also Pettengill v. United States, 205 F. Supp. 10 (D. Vt. 1962) (declaratory judgment granted to husband and wife, as tenants by the entirety, to remove lien where husband alone was delinquent taxpayer).

See Commissioner v. Proctor, infra page 1090 (refusal to give effect to a clause nullifying a gift if it was held subject to federal gift tax).

3. *Injunction if IRS fails to send 90-day letter.* Notwithstanding §7421(a), assessment and collection can be enjoined if the Commissioner fails to send the taxpayer a 90-day letter, §6213(a). This provision protects the taxpayer's right to go to the Tax Court without paying the tax. In keeping with this restriction, assessment and collection can be restrained until the 90-day period for filing a petition in the Tax Court has run and, if a petition is filed, until the Tax Court's decision has become final. For the use of jeopardy assessments to avoid this delay in collection, see infra.

4. *References.* Lipton, Enjoining Assessment or Collection of a Tax, 18 N.Y.U. Inst. on Fed. Taxation 957 (1960); Greener, The Injunction in Federal Tax Cases, 21 Tenn. L. Rev. 237 (1950).

2. *Jeopardy Assessments*

Section 6861(a) of the 1954 Code, relating to jeopardy assessments, is substantially the same as §273(a) of the 1939 Code.

Section 6863(b)(3), restricting sales of seized property in the case of a jeopardy assessment, is new.

As the extract from Bull v. United States, supra page 923, shows, taxes have traditionally been collected by summary methods, with the taxpayer who disputes liability being afforded a hearing only after collection. The Tax Court procedure for challenging a deficiency breaks with tradition by allowing the taxpayer to litigate before paying, the taxpayer's right to go to the Tax Court being protected by the prohibition in §6213(a) on the making of an assessment until a 90-day letter has been sent to him and, if he files a petition with the Tax Court, until its decision becomes final. But this restriction is in turn subject to an exception: §6861(a) provides that if the Treasury "believes that the assessment or collection of a deficiency . . . will be jeopardized by delay," the deficiency may be assessed forthwith. The taxpayer may then stay collection by filing a bond to insure ultimate payment. If a bond is not filed by the taxpayer, the government may proceed to collect the tax, subject to the restriction of §6863(b)(3) on the sale of seized property. A jeopardy assessment does not prevent the taxpayer from litigating in the Tax Court.

The jeopardy assessment is a drastic remedy, and it is used by the government primarily against taxpayers who are wasting or concealing their assets and in fraud cases. There is a tendency in these cases to overassess, in order to protect the government against any possible loss, and §6861(g) was enacted in 1953 to authorize the Secretary to abate the jeopardy assessment "if he finds that jeopardy does not exist."

The courts have been loath to re-examine the administrative officer's judgment that a delay in assessment or collection would be prejudicial to the revenue, and in Brown-Wheeler Co. v. Commissioner, 21 B.T.A. 755 (1930), the Tax Court said that §6861(a) "vests discretionary powers in the Commissioner over which we have no control." See also Homan Mfg. Co. v. Long, 242 F.2d 645 (7th Cir. 1957): "Under §6861 the government official has power to act when he *believes*

collection will be jeopardized by delay. His belief is justification for placing the statutory clamp on a taxpayer's assets." While judicial review would no doubt be possible if the official acted corruptly or if his action violated the constitutional guarantees of due process, there is in ordinary cases nothing the taxpayer can do to challenge a jeopardy assessment. For a due process argument, see United States v. Brodson, 241 F.2d 107 (7th Cir. 1957), reversing an order of the District Court which dismissed an indictment for tax evasion on the ground that a jeopardy assessment had made it impossible for the defendant to defend himself adequately. The district judge's action was based on the theory that the defendant required the aid of an accountant, income having been computed by the government by the net worth method, that he could not hire an accountant because the jeopardy assessment had blocked his assets, and that the court had no power to appoint an accountant. The Court of Appeals, in reinstating the indictment, did not exclude the possibility that a conviction would have to be reversed on due process grounds if a review of the trial indicated that in fact the defendant had been unable to make an adequate defense. (Query whether the argument would succeed in a civil case in which an accountant's aid would be helpful or necessary.) The District Court thereupon continued the criminal case pending determination of the taxpayer's civil liability, so that the funds seized or impounded by the jeopardy assessment could be used to finance defense of the criminal case if the assessment turned out to be excessive. United States v. Brodson, 155 F. Supp. 407 (E.D. Wis. 1957).

NOTE

1. *Closing the taxable year.* Another drastic device available to the Commissioner when he deems collection of the tax to be in jeopardy is to close the taxable year and demand immediate payment of the tax on the income so far earned during the current year plus the tax on the preceding year's income. In the case of a taxpayer filing on the calendar year basis, this would permit the Commissioner to demand payment on March 1 of the tax for the preceding year plus a tax on the earnings in January and February. See §6851.

2. *References.* Kaminsky, Administrative Law and Judicial Review of Jeopardy Assessments Under the Internal Revenue Code, 14 Tax L. Rev. 545 (1959); Gould, Jeopardy Assessments: When They May Be Levied and What to Do About Them, 18 N.Y.U. Inst. on Fed. Taxation 937 (1960).

3. *Transferee Liability*

Sections 6901 and 6902, relating to transferee liability, are derived, with minor changes, from §311 of the 1939 Code.

COMMISSIONER v. STERN

357 U.S. 39 (1958)

MR. JUSTICE BRENNAN delivered the opinion of the Court.

Respondent petitioned the Tax Court for redetermination of the liability assessed against her for her deceased husband's unpaid income tax deficiencies. The Tax Court held that, as beneficiary of proceeds of her husband's life insurance exceeding the amount of the deficiencies, the respondent was liable for the full amount of the deficiencies. The Court of Appeals reversed, 242 F.2d 322, holding that the respondent was not liable even to the extent of the amount of the cash surrender values of the policies, which was less than the amount of the deficiencies. We granted certiorari. 355 U.S. 810.

Dr. Milton J. Stern died a resident of Lexington, Kentucky, on June 12, 1949. Nearly six years later the Tax Court held that Dr. Stern had been deficient in his income taxes for the years 1944 through 1947 and was liable for the amount, including interest and penalities, of $32,777.51. Because the assets of the estate were insufficient to meet this liability, the Commissioner proceeded under [§6901] against respondent, Dr. Stern's widow, as the beneficiary of life insurance policies held by him. The proceeds and the cash surrender value of these policies at Dr. Stern's death totaled $47,282.02 and $27,259.68 respectively. The right to change the beneficiary and to draw down the cash surrender value of each policy had been retained until death by Dr. Stern. There were no findings that Dr. Stern paid any premiums with intent to defraud his creditors or that he was insolvent at any time prior to this death.

The Court of Appeals rested its decision upon two grounds: (1) that the respondent beneficiary was not a transferee within the meaning of [§6901], Tyson v. Commissioner, 212 F.2d 16; and (2) that in any event Kentucky statutes, Ky. R.S., 1948, §§297.140, 297.150, limit the beneficiary's liability to creditors of the deceased insured to the amount of the premiums paid by the insured in fraud of creditors, and consequently there was no liability since there was no evidence that Dr. Stern paid any premium in fraud of his creditors. Without intimating any view as to the correctness of the first holding of the Court of Appeals we find it unnecessary to decide whether the respondent was a transferee within the meaning of [§6901] [1] because we hold that the Kentucky statutes govern the question of the beneficiary's liability and create no liability of the respondent to the Government in the circumstances of this case.

First. Section [6901(a)] provides that "The liability, at law or in equity, of a transferee of property of a taxpayer, in respect of the tax . . . imposed upon the taxpayer by this chapter" shall be "assessed, collected, and paid in the same manner and subject to the same provisions and limitations as in the case of a deficiency in a tax imposed by this chapter. . . ." The decisions of the Court of Appeals and the Tax Court have been in conflict on the question whether the substantive liability enforced under [§6901(a)] is to be determined by state or federal law. Compare, e.g., Rowen v. Commissioner, 215 F.2d 641, and Botz v. Helvering, 134 F.2d 538, with United States v. Bess, 243 F.2d 675, and Stoumen v. Commissioner, 27 T.C. 1014. This Court has expressly left the question open. Phillips v. Commissioner, 283 U.S. 589, 602.

The courts have repeatedly recognized that [§6901] neither creates nor defines a substantive liability but provides merely a new procedure by which the Government may collect taxes. . . . Prior to the enactment of §280 of the Revenue Act of 1926, 44 Stat. 9, 61, the predecessor of [§6901], the rights of the Government as creditor, enforceable only by bringing a bill in equity or an action at law, depended upon state statutes or legal theories developed by the courts for the protection of private creditors, as in cases where the debtor had transferred his property to another. . . . Phillips v. Commissioner, supra, at 592, n.2; This procedure proved unduly cumbersome, however, in comparison with the summary administrative remedy allowed against the taxpayer himself, Rev. Stat.

[1] The Court of Appeals in this case followed its own prior decision in Tyson v. Commissioner, 212 F.2d 16, in holding that Mrs. Stern as beneficiary was not a "transferee" of any part of the proceeds within the meaning of [§6901]. Other Courts of Appeals have held that the beneficiary is a transferee only to the extent of the cash surrender value existing at the time of the insured's death. Rowen v. Commissioner, 215 F.2d 641; United States v. Bess, 243 F.2d 675. The Tax Court, on the other hand, has held that the beneficiary is the transferee of the entire proceeds. Stoumen v. Commissioner, 27 T.C. 1014.

§3187, as amended by the Revenue Act of 1924, 43 Stat. 343. The predecessor section of [§6901] was designed "to provide for the enforcement of such liability to the Government by the procedure provided in the act for the enforcement of tax deficiencies." S. Rep. No. 52, 69th Cong., 1st Sess. 30. "Without in any way changing the extent of such liability of the transferee under existing law, . . . [this section] enforces such liability . . . in the same manner as liability for a tax deficiency is enforced; that is, notice by the commissioner to the transferee and opportunity either to pay and sue for refund or else to proceed before the Board of Tax Appeals, with review by the courts. Such a proceeding is in lieu of the present equity proceeding. . . ." H.R. Conf. Rep. No. 356, 69th Cong., 1st Sess. 43-44. Therefore, since [§6901] is purely a procedural statute we must look to other sources for definition of the substantive liability. Since no federal statute defines such liability, we are left with a choice between federal decisional law and state law for its definition.

Second. The Government urges that, to further "uniformity of liability," we reject the applicability of Kentucky law in favor of having the federal courts fashion governing rules. Cf. Clearfield Trust Co. v. United States, 318 U.S. 363. But a federal decisional law in this field displacing state statutes as determinative of liability would be a sharp break with the past. Federal courts, in cases where the Government seeks to collect unpaid taxes from persons other than the defaulting taxpayer, have applied state statutes, . . . and the Government itself has urged reliance upon such statutes in similar cases, G.C.M. 2514, VI-2 Cum. Bull. 99; G.C.M. 3491, VII-1 Cum. Bull. 147. The Congress was aware of the use of state statutes when the enactment of the predecessor section to [§6901] was under consideration, for the Congress in disclaiming any intention "to define or change existing liability," S. Rep. No. 52, 69th Cong., 1st Sess. 30, identified "existing liability" as liability ensuing "[b]y reason of the trust fund doctrine and various State statutory provisions. . . ." H.R. Conf. Rep. No. 356, supra, at 43.

It is true that, in addition to reliance upon state statutes, the Government invoked principles judicially developed for the protection of private creditors, in cases where the debtor had transferred his property to another and been left insolvent. . . . In such cases the federal courts applied a "general law" which did not distinguish between federal and state decisional law. But the fact remains that the varying definitions of liability under state statutes resulted in an absence of uniformity of liability. Yet Congress, with knowledge that this was "existing law" at the time the predecessor section to [§6901] was enacted, has refrained from disturbing the prevailing practice. Uniformity is not always the federal policy. Under §70 of the Bankruptcy Act, for instance, state law is applied to determine what property of the bankrupt has been transferred in fraud of creditors. What is a good transfer in one jurisdiction might not be so in another.

Since Congress has not manifested a desire for uniformity of liability, we think that the creation of a federal decisional law would be inappropriate in these cases. In diversity cases, the federal courts must now apply state decisional law in defining state-created rights, obligations, and liabilities. Erie R. Co. v. Tompkins, 304 U.S. 64. They would, of course, do so in diversity actions brought by private creditors. Since the federal courts no longer formulate a body of federal decisional law for the larger field of creditors' rights in diversity cases, any such effort for the small field of actions by the Government as a creditor would be necessarily episodic. That effort is plainly not justified when there exists a flexible body of pertinent state law continuously being adapted to changing circum-

stances affecting all creditors. Accordingly we hold that, until Congress speaks to the contrary, the existence and extent of liability should be determined by state law.

Third. The Court of Appeals held in this case that under the applicable Kentucky law the beneficiary of a life insurance policy is not liable to the insured's creditors, at least where, as here, the premiums have not been paid in fraud of creditors, and that therefore no liability of the respondent exists under state law to any creditor, including the Government. The parties do not contest this construction of local law.

The Government, however, argues in its brief, "Just as in the situation where a tax lien has attached it is held that state law may not destroy that lien, so here, where a tax liability is imposed by Congress, the state may not provide exemptions." We agree that state law may not destroy a tax lien which has attached in the insured's life. We held today in United States v. Bess, 357 U.S. 51, that a New Jersey statute, similar to the Kentucky statutes, could not defeat the attachment in the insured's lifetime of a federal tax lien under §3670 against the cash surrender value of the policy, or prevent enforcement of the lien out of the proceeds received by the beneficiary on the insured's death. We might also agree that a State may not provide exemptions from a tax liability imposed by Congress. The fallacy in the Government's argument is in the premise that Congress has imposed a tax liability against the beneficiary. We have concluded that Congress has not seen fit to define that liability and that none exists except such as is imposed by state law. Thus there is no problem here of giving effect to state exemption provisions when federal law imposes such liability. The Government's substantive rights in this case are precisely those which other creditors would have under Kentucky law. The respondent is not liable to the Government because Kentucky law imposes no liability against respondent in favor of Dr. Stern's other creditors.

Affirmed.

MR. JUSTICE BLACK, whom THE CHIEF JUSTICE and MR. JUSTICE WHITTAKER join, dissenting.

We are concerned here with a suit against the United States to determine the liability of a party for federal income taxes. In my judgment it is a mistake to look to state law to decide that liability. The laws of the several States are bound to vary widely with respect to the responsibility of transferees for the obligations of their transferors. Therefore application of state law leads to the anomalous result that transferees will be liable for federal taxes in one State but not in another even though they stand in precisely the same position. I believe that such uneven application of what this Court has characterized as "a nationwide scheme of taxation," Burnet v. Harmel, 287 U.S. 103, 110, is thoroughly unwise and is not required by the Constitution, by Act of Congress, or by any compelling practical considerations.

In my view, liability for federal taxes should be determined by uniform principles of federal law, in the absence of the plainest congressional mandate to the contrary. Whereas here Congress has provided no standards which define the liability of a transferee for the taxes of his transferor the federal courts themselves should fashion a uniform body of controlling rules which fairly implement the collection of government revenues. . . . It can hardly be denied that uniformity in the imposition and collection of federal taxes has always been regarded as extremely desirable in this country. Indeed those who framed the Constitution deemed it so important that they expressly required that "all Duties, Imposts and Excises [levied by Congress] shall be uniform throughout the United States." Art. I, §8. Cf. Art. I, §§2, 9. Taxpayers should be treated equally

without regard to the fortuity of residence; and the additional complication and inconvenience in the administration of an already complex federal tax system which is certain to follow an attempt to apply the differing laws of 48 States to transferee liability ought to be avoided, if at all possible.

Here, Congress has never directed that the tax liability of a transferee be determined by state law. The legislative history of §280 of the Revenue Act of 1926 certainly falls far short of a congressional mandate to that effect. Prior to that Act the federal courts had applied general principles of equity to determine the liability of transferees for federal taxes, without regard to state law, except for a few instances where state statutes apparently were more favorable to the Commissioner. Both Senate and House Committees emphasized that §280 was simply a procedural provision not affecting the substantive liability of a transferee as it had been previously developed by the federal courts. S. Rep. No. 52, 69th Cong., 1st Sess. 30; H.R. Conf. Rep. No. 356, 69th Cong., 1st Sess. 43-44. And the House Conference Committee went on to express the hope that the newly created Board of Tax Appeals would gradually fashion a uniform body of principles to govern transferee liability. H.R. Conf. Rep. No. 356, supra, at 44. All this is hardly consistent with the notion that state law was to be decisive; if anything, it indicates precisely the contrary. It might be added that the Tax Court, measuring up to the expectations of the House Committee, has persistently endeavored to develop consistent standards to determine transferee liability despite the opposition of several Courts of Appeals. See, e.g., Muller v. Commissioner, 10 T.C. 678; Leary v. Commissioner, 18 T.C. 139; Bales v. Commissioner, 22 T.C. 355; Stoumen v. Commissioner, 27 T.C. 1014.

I would hold, as a matter of federal law, that where a transferee receives property from a taxpayer who is left with insufficient assets to pay his federal taxes the transferee is liable for those taxes to the extent he has not given fair consideration for the property received. This has been the rule applied by those courts which have heretofore determined transferee liability on the basis of federal law. See, e.g., Pearlman v. Commissioner, 153 F.2d 560; Updike v. United States, 8 F.2d 913; Stoumen v. Commissioner, 27 T.C. 1014. Such a rule has long-standing antecedents in the federal courts which may be traced back, in part, at least as far as the noted decision by Justice Story in Wood v. Drummer, 30 Fed. Cas. 435. It would operate to prevent tax evasion, and yet not impose an unfair burden on transferees.

Turning to the present case, I agree with the Court in United States v. Bess, 357 U.S. 51, that the cash surrender values of insurance policies, but not the proceeds, are property of the insured for purposes of the federal tax laws which pass to the beneficiary of the policy upon the insured's death. Here it appears that the insured had insufficient assets at the time of his death to satisfy his unpaid income taxes. Therefore I would hold the beneficiary of his policies, Mrs. Stern, responsible for the unpaid taxes to the extent of the cash surrender value of those policies just before he died.

NOTE

1. *Basis of transferee liability.* Transferee liability has already been encountered in several cases. Healy v. Commissioner, supra page 854; see also the *Court Holding Co.* and *Cumberland Public Service Co.* cases, supra pages 675, 676. Such liability is occasionally based upon a contract by which the transferee of assets (e.g., a successor corporation or partner) assumes the obligations of another taxpayer. More frequently, however, non-tax statutes for the benefit of creditors and equitable doctrines relating to fraudulent conveyances, "trust funds" for creditors, and the like are invoked. See, for example, Ginsberg v. Commissioner, 35 T.C. 1148 (1961) (gratuitous transfer of stock

to children). For more on the enforcement of the tax lien against life insurance, see Meyer v. United States, 375 U.S. 233 (1963).

See Healy v. Commissioner, supra page 856, note 5, stating that the secondary liability of a transferee requires proof by the government that it cannot collect from the transferor.

2. *Liability of fiduciaries for unpaid taxes.* Section 6901(a)(1)(B) permits the same strong-arm tactics against a fiduciary who distributes assets in his charge without first paying federal taxes, at least if he knows or should know of them. See Irving Trust Co. v. Commissioner, 40 B.T.A. 204 (1939). For the difference between transferee liability and fiduciary liability, see Grieb v. Commissioner, 36 T.C. 156 (1961).

See §6501(d), permitting a fiduciary to demand a prompt assessment of tax so as to facilitate distribution without fear of a later assessment, and note also the possibility of a closing agreement for this purpose, supra page 908.

3. *Shareholder suits.* Occasionally a stockholder has successfully sued his corporation to enjoin payment of a tax. A famous example is Pollock v. Farmers Loan & Trust Co., supra page 5; and see Stanton v. Baltic Mining Co., supra page 70. The device may prevent a voluntary payment of the tax by the corporation, but it will not prevent an assessment and collection by the government. See Reinecke v. Peacock, 3 F.2d 583 (7th Cir. 1924), dismissed for want of jurisdiction, 271 U.S. 643 (1926). If the stockholder's action succeeds in restraining a voluntary payment on the ground that the tax is not owing, however, will the corporation be in a better position on going to the Tax Court or on suing for a refund? If the outcome of the stockholder's suit is of no weight in a later deficiency or refund action, is there any reason why a court of equity should entertain such suits? How can the stockholder establish that there is a threatened loss to the corporation, in view of the availability to the corporation of the Tax Court and refund procedures?

SECTION C. TAX LITIGATION

A taxpayer who receives a 90-day letter may file a petition in the Tax Court and (unless a jeopardy assessment is made) defer payment of the tax until the litigation is concluded. In the alternative, he may pay the tax, file a claim for a refund, and sue in either the federal District Court or in the Court of Claims (if the claim is rejected or is held by the Internal Revenue Service without action for more than six months). If the taxpayer has waived the 90-day letter, by executing a Form 870 (supra p. 910), however, his only remedy is a claim for refund, followed by suit in the District Court or Court of Claims. And the taxpayer who paid a tax voluntarily and then wants a refund (e.g., because he has discovered an error in his return) is similarly confined to the refund route and may not litigate in the Tax Court.

For the taxpayer who has received a 90-day letter and is comparing the Tax Court as a forum with the District Court and Court of Claims, one or more of the following points may be controlling:

1. If he goes to the Tax Court, he need not pay the tax in advance.* If he wishes to pay (so as to avoid the interest cost if he loses, or because he is confident of success and wants a sure investment at 6 per cent interest), however, he will not lose his right to litigate in the Tax Court if he pays after receiving the 90-day letter. §6213(b)(3).

2. The various courts may have adopted divergent constructions of the Code, one of which is more favorable to the taxpayer than the others. Moreover, equitable doctrines, such as recoupment, may be applied by the District Court or Court of Claims, but not by the Tax Court. Supra page 875.

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* In Flora v. United States, 357 U.S. 63 (1958), the Supreme Court held that a taxpayer must pay the full amount of a tax deficiency before challenging it by a suit for refund. During the next term, the Supreme Court took the unusual step of granting a rehearing. By a 5-to-4 vote, it then adhered to the original decision. 362 U.S. 145 (1960).

3. In the District Court, the taxpayer (or the government) may demand a trial by jury, which may (or may not) be an advantage. See Walston, The Use of Juries in Federal Civil Income Tax Cases, 39 Taxes 144 (1961); Damsky v. Zavatt, 289 F.2d 46 (2d Cir. 1961) (exhaustive historical review of jury trial in tax cases); Rinkey v. Knox, supra page 716 (use of jury in complex spin-off case); Cole v. Usry, 294 F.2d 426 (5th Cir. 1961) (scope of review in jury cases). Moreover, the District Court, whether the trial is by jury or not, may be more receptive to arguments based on local custom or tradition or on the taxpayer's reputation and standing in the community.

4. The taxpayer may appeal as of right from either the Tax Court or the District Court to the Court of Appeals, while the Court of Claims is reviewed only by the Supreme Court, and by certiorari.

5. A petition to the Tax Court permits a judgment against the taxpayer for a deficiency larger than was originally asserted for the year in question regardless of the statute of limitations. In the District Court, however, a barred deficiency may be used by the government only by way of set-off, not as an affirmative counterclaim. See pages 906-907 supra.

In most cases, there are no compelling reasons for choosing one forum rather than another, and economic and psychological resistance to paying the tax in advance often results in selecting the Tax Court. On June 30, 1962, there were about 9000 cases pending in the Tax Court, as against about 2700 in the District Courts and 500 in the Court of Claims.

See the comprehensive study of Ferguson, Jurisdictional Problems in Federal Tax Controversies, 48 Iowa L. Rev. 312 (1963); Flora v. United States, 362 U.S. 145 (1959) (extended review of legislative background of tax litigation in District Courts and Tax Court).

1. *Tax Court*

Time for filing petition. The requirement of §6213(a) that the petition to the Tax Court be filed within 90 days after the notice of deficiency is mailed is jurisdictional, and the period cannot be extended by the Tax Court for reasons of equity. Before the 1954 Code was enacted, there were a number of cases involving petitions whose delivery was delayed because of interruptions in normal mail service. See Weiss, When Is a Petition "Filed" in the Tax Court, 8 Tax L. Rev. 473 (1953). Section 7502 now provides that the date on which a petition sent by mail is postmarked shall be deemed to be the date of delivery if the petition is actually delivered later; and that if the petition is sent by registered mail, registration shall be prima facie evidence that it was delivered.

Status of the Tax Court. Section 7441 provides that the Board of Tax Appeals is "an independent agency in the Executive Branch of the Government" and that (commencing January 1, 1943) it "shall be known as the Tax Court of the United States." Is it a court or an administrative agency? The commentators have written more on this subject than the courts. Levenson, Effect of the Administrative Procedure Act on Decisions of the Tax Court," 2 Tax L. Rev. 103 (1946); Brown, The Nature of the Tax Court of the United States, 10 U. of Pitt. L. Rev. 298 (1949); Gribbon, Should the Judicial Character of the Tax Court Be Recognized? 24 Geo. Wash. L. Rev. 619 (1956). The principal practical issue was whether the Tax Court was subject to the Administrative Procedure Act, enacted in 1946, which sanctioned stricter judicial review than the *Dobson* case, supra page 862, but this question became moot when the enactment of §7482(a) modified the *Dobson* rule.

See also Kennedy Name Plate Co. v. Commissioner, 170 F.2d 196 (9th Cir. 1948); Stern v. Commissioner, 215 F.2d 701 (3d Cir. 1954) (Tax Court's "powers are

wholly judicial in character"); Lasky v. Commissioner, 235 F.2d 97 (9th Cir. 1956) (Tax Court is "not a court at all but merely an administrative agency"); Fairmont Aluminum Co. v. Commissioner, 22 T.C. 1377 (1954) ("Whatever label might be used to characterize this Court for various purposes, its proceedings are, and were intended by Congress to be, in every sense of the word, judicial").

Appellate review of Tax Court: the "inverted triangle." Decisions of the Tax Court are reviewed by the eleven Courts of Appeals. The Tax Court early adopted the position that if it was reversed by a Court of Appeals and was later faced with the same issue, it would "thoroughly reconsider the problem in the light of the reasoning of the reversing appellate court," but stick to its guns if not persuaded that it was wrong. Moreover, it follows this practice even if the later case will probably be appealed to the same appellate court by which it was previously reversed. In Lawrence v. Commissioner, 27 T.C. 713 (1957), it gave the following reasons for doing so:

> The Tax Court has always believed that Congress intended it to decide all cases uniformly, regardless of where, in its nationwide jurisdiction, they may arise, and that it could not perform its assigned functions properly were it to decide one case one way and another differently merely because appeals in such cases might go to different Courts of Appeals. Congress, in the case of the Tax Court, "inverted the triangle" so that from a single national jurisdiction, the Tax Court appeals would spread out among 11 Courts of Appeals, each for a different circuit or portion of the United States. Congress faced the problem in the beginning as to whether the Tax Court jurisdiction and approach was to be local or nationwide and made it nationwide. Congress expected the Tax Court to set precedents for the uniform application of the tax laws, insofar as it would be able to do that. . . .
>
> The Tax Court feels that it is adequately supported in this belief not only by the creating legislation and legislative history but by other circumstances as well. The Tax Court never knows, when it decides a case, where any subsequent appeal from that decision may go, or whether there will be an appeal. It usually, but not always, knows where the return of a taxpayer was filed and, therefore, the circuit to which an appeal could go, but the law permits the parties in all cases to appeal by mutual agreement to any Court of Appeals. Sec. 7482(b)(2), I.R.C. 1954. Furthermore, it frequently happens that a decision of the Tax Court is appealable to two or even more Courts of Appeals. A few examples will illustrate. A corporation, having stockholders scattered over the United States, makes a distribution to all. The Commissioner holds it taxable as a dividend from accumulated earnings. The stockholders join in a trial before the Tax Court which decides the issue as to all petitioning stockholders, contrary to a decision of Court of Appeals A, which reversed a prior Tax Court decision, but perhaps in line with an affirming decision of Court of Appeals B. . . . If it had rendered a separate different decision for those stockholders in Circuit A, what amount of accumulated earnings would remain for future distribution? Another situation was presented by the *Richmond Hosiery Mills.* That corporation filed its corporate returns for 3 years with the collector of internal revenue for the district of Georgia and for 1 intermediate year with the collector of internal revenue for the district of Tennessee. It received one notice of deficiency and filed a single petition in the Tax Court, each covering all 4 years. The Tax Court decided the case for all 4 years in a Memorandum Opinion and entered but one decision in the proceeding. The taxpayer took appeals to the Courts of Appeals for both the Fifth Circuit and the Sixth Circuit, in the former as to 3 of the years and in the latter as to a single year. . . . Or suppose partners live in different circuits. Are the decisions of the Tax Court as to them to vary accordingly?

But see Stacey Mfg. Co. v. Commissioner, 237 F.2d 605 (6th Cir. 1956) (Tax Court "is not lawfully privileged to disregard and refuse to follow, as the settled law of the circuit, an opinion of the court of appeals for that circuit"). For further discussion of this problem by the Tax Court, see Automobile Club of New York, Inc. v. Commissioner, 32 T.C. 906, 917, 923-926 (1959); see also Hear-

ings on Treasury-Post Office Department Appropriations, House Appropriations Committee, 84th Cong., 2d Sess. 461-465 (1956); Dwan, Administrative Review of Judicial Decisions: Treasury Practice, 46 Colum. L. Rev. 581, 591-594 (1946).

References. For Tax Court pleading, motion, and trial procedures, see Locke, Motions and Certain Other Procedures in the Tax Court of the United States, 41 Taxes 391 (1963); Keir, The Preparation and Trial of Cases in the Tax Court of the United States (1952); Bickford, Successful Tax Practice 294-361 (3d ed. 1956); Casey, Federal Tax Practice, cc. 6-8 (1955, with supplements).

For descriptions of Tax Court procedure by its judges, see Kern, The Process of Decision in the United States Tax Court, 8 N.Y.U. Inst. on Fed. Taxation 1013 (1950); Murdock, What Has the Tax Court of the United States Been Doing? 31 A.B.A.J. 297 (1945); Raum, Tax Court Litigation, 1957 So. Calif. Tax Inst. 631.

For some practical consequences of the "inverted triangle" scheme of appellate review, see Nevitt, Achieving Uniformity Among the 11 Courts of Last Resort, 34 Taxes 311 (1956). For proposals for a single Court of Tax Appeals, see Griswold, The Need for a Court of Tax Appeals, 57 Harv. L. Rev. 1153 (1944); Miller, Can Tax Appeals Be Centralized? 23 Taxes 303 (1945); Pope, A Court of Tax Appeals: A Call for Re-examination, 39 A.B.A.J. 275 (1953); Del Cotto, The Need for a Court of Tax Appeals: An Argument and a Study, 12 Buffalo L. Rev. 5 (1962); Surrey, Some Suggested Topics in the Field of Tax Administration, 25 Wash. U.L.Q. 399, 414-423 (1940). For another prescription, see Eisenstein, Some Iconoclastic Reflections on Tax Administration, 58 Harv. L. Rev. 477 (1945).

2. *District Courts and Court of Claims*

For many years, the taxpayer seeking a refund of federal income taxes has had a choice of forums: (a) suit against the Collector (now the District Director) of Internal Revenue who collected the tax, in the federal District Court of the defendant's residence; (b) suit against the United States in the Court of Claims; and (c) suit against the United States in the federal District Court of the plaintiff's residence. The United States could formerly be sued in the District Court only if the claim did not exceed $10,000 or if the Collector who collected the tax was dead or out of office, but these restrictions were eliminated in 1954. No matter which forum is selected, the taxpayer cannot maintain a suit unless he has filed a timely claim for refund with the Internal Revenue Service (supra p. 906) which either has been rejected or has been before the Service without action for six months or more. If the claim has been rejected, suit must be brought within two years after notice of its disallowance. §§7422 and 6532.

The suit against the Collector* was a procedural device created by the courts to avoid the impact of sovereign immunity to suit and "is today an anomalous relic of bygone modes of thought." George Moore Ice Cream Co. v. Rose, 289 U.S. 373, 382 (1933). Originally the Collector was protected against personal liability by the requirement that the taxpayer intending to claim a refund must pay under protest, so that the Collector would withhold the tax from the Treasury until the taxpayer's claim was settled; but for more than a century the Collector has been required to pay the tax over to the Treasury and has been protected against personal loss by what is now §2006 of 28 U.S.C., providing that any judgment shall be paid by the Treasury if the court certifies that probable cause existed or that the Collector acted under official orders.

Although the United States is thus the real party in interest, the suit against

* The "Collector" is now the "District Director," but the tradition of calling the personal action a suit "against the Collector" is so strong that the label has been preserved in this discussion.

the Collector has never been completely liberated from the judicial theory that it is a purely personal action, with a variety of curious results. At one time, for example, a suit against a collector was not res adjudicata in a later suit, for the same tax year, against the United States. See Woodworth v. Kales and Kales v. United States, supra page 919. This rule was changed by statute, now §7422 (c), in 1942. Another curiosity of the suit against the Collector was that it would fail if the tax had been paid not in cash, but by crediting an overpayment for another period, since the defendant Collector had not "collected" anything. This rule has also been altered, by §7422(d), enacted in 1949. There are other procedural quirks in the suit against the Collector, however, which have not been removed by statute. If the taxpayer sues the wrong Collector, he cannot amend his complaint to substitute the correct Collector or the United States after the statute of limitations has run, since the amendment is the equivalent of a new action. It is possible that a suit against a Collector is improper if the tax was due when collected and became an overpayment only by reason of subsequent events: e.g., a loss carryback, a retroactive change in the statute, etc. A Collector who is sued may set up a deficiency for the same year by way of offset, but a counterclaim against the taxpayer requires the intervention of the United States. For these and other aspects of the suit against the Collector, see Plumb, Tax Refund Suits Against Collectors of Internal Revenue, 60 Harv. L. Rev. 685 (1947) (partly outmoded by statutory changes); Hammond-Knowlton v. Hartford-Connecticut Trust Co., 89 F.2d 175 (2d Cir. 1937).

Two statutory changes in 1954 may reduce the number of suits against the Collector and thus mitigate in practice the anomolous consequences of the "personal" character of this procedural device. One change, already mentioned, was the elimination of the $10,000 limit on suits against the United States in the federal District Court; and the other was the extension of trial by jury to suits against the United States. Except for differences in venue and the assessment of costs, there no longer seems to be any reason for suing the Collector rather than the United States, though it is perhaps too early to assert flatly that there are no other residual differences between the two forms of action.

For a comprehensive study of the Court of Claims, see Pavenstedt, The United States Court of Claims as a Forum for Tax Cases, 15 Tax L. Rev. 1 and 201 (1959-1960).

3. *Res Judicata*

COMMISSIONER v. SUNNEN

333 U.S. 591 (1948)

MR. JUSTICE MURPHY delivered the opinion of the Court.

The problem of the federal income tax consequences of intra-family assignments of income is brought into focus again by this case.

The stipulated facts concern the taxable years 1937 to 1941, inclusive, and may be summarized as follows:

The respondent taxpayer was an inventor-patentee and the president of the Sunnen Products Company, a corporation engaged in the manufacture and sale of patented grinding machines and other tools. He held 89% or 1,780 out of a total of 2,000 shares of the outstanding stock of the corporation. His wife held 200 shares, the vice-president held 18 shares and two others connected with the corporation held one share each. The corporation's board of directors consisted of five members, including the taxpayer and his wife. This board was elected

annually by the stockholders. A vote of three directors was required to take binding action.

The taxpayer had entered into several non-exclusive agreements [in 1928 and certain later years] whereby the corporation was licensed to manufacture and sell various devices on which he had applied for patents. In return, the corporation agreed to pay to the taxpayer a royalty equal to 10% of the gross sales price of the devices. These agreements did not require the corporation to manufacture and sell any particular number of devices; nor did they specify a minimum amount of royalties. Each party had the right to cancel the licenses, without liability, by giving the other party written notice of either six months or a year. In the absence of cancellation, the agreements were to continue in force for ten years. The board of directors authorized the corporation to execute each of these contracts. No notices of cancellation were given. . . .

The taxpayer at various times assigned to his wife all his right, title and interest in the various license contracts. She was given exclusive title and power over the royalties accruing under these contracts. All the assignments were without consideration and were made as gifts to the wife, those occurring after 1932 being reported by the taxpayer for gift tax purposes. The corporation was notified of each assignment. . . .

Relying upon its own prior decision in Estate of Dodson v. Commissioner, 1 T.C. 416, the Tax Court held that, with one exception, all the royalties paid to the wife from 1937 to 1941 were part of the taxable income of the taxpayer. 6 T.C. 431. The one exception concerned the royalties of $4,881.35 paid in 1937 under the 1928 agreement. In an earlier proceeding in 1935, the Board of Tax Appeals dealt with the taxpayer's income tax liability for the years 1929-1931; it concluded that he was not taxable on the royalties paid to his wife during those years under the 1928 license agreement. This prior determination by the Board caused the Tax Court to apply the principle of res judicata to bar a different result as to the royalities paid pursuant to the same agreement during 1937.

The Tax Court's decision was affirmed in part and reversed in part by the Eighth Circuit Court of Appeals. 161 F.2d 171. Approval was given to the Tax Court's application of the res judicata doctrine to exclude from the taxpayer's income the $4,881.35 in royalties paid in 1937 under the 1928 agreement. But to the extent that the taxpayer had been held taxable on royalties paid to his wife during the taxable years of 1937-1941, the decision was reversed on the theory that such payments were not income to him. Because of that conclusion, the Circuit Court of Appeals found it unnecessary to decide the taxpayer's additional claim that the res judicata doctrine applied as well to the other royalties (those accruing apart from the 1928 agreement) paid in the taxable years. We then brought the case here on certiorari, the Commissioner alleging that the result below conflicts with prior decisions of this Court.

If the doctrine of res judicata is properly applicable so that all the royalty payments made during 1937-1941 are governed by the prior decision of the Board of Tax Appeals, the case may be disposed of without reaching the merits of the controversy. We accordingly cast our attention initially on that possibility, one that has been explored by the Tax Court and that has been fully argued by the parties before us.

It is first necessary to understand something of the recognized meaning and scope of res judicata, a doctrine judicial in origin. The general rule of res judicata applies to repetitious suits involving the same cause of action. It rests upon considerations of economy of judicial time and public policy favoring the establishment of certainty in legal relations. The rule provides that when a court of competent jurisdiction has entered a final judgment on the merits of a cause of

action, the parties to the suit and their privies are thereafter bound "not only as to every matter which was offered and received to sustain or defeat the claim or demand, but as to any other admissible matter which might have been offered for that purpose." Cromwell v. County of Sac, 94 U.S. 351, 352, 24 L. Ed. 195. The judgment puts an end to the cause of action, which cannot again be brought into litigation between the parties upon any ground whatever, absent fraud or some other factor invalidating the judgment. See von Moschzisker, "Res Judicata," 38 Yale L.J. 299; Restatement of the Law of Judgment, §§47, 48.

But where the second action between the same parties is upon a different cause of demand, the principle of res judicata is applied much more narrowly. In this situation, the judgment in the prior action operates as an estoppel, not as to matters which might have been litigated and determined, but "only as to those matters in issue or points controverted, upon the determination of which the finding or verdict was rendered." Cromwell v. County of Sac, supra, 353 of 94 U.S. . . . Since the cause of action involved in the second proceeding is not swallowed by the judgment in the prior suit, the parties are free to litigate points which were not at issue in the first proceeding, even though such points might have been tendered and decided at that time. But matters which were actually litigated and determined in the first proceeding cannot later be relitigated. Once a party has fought out a matter in litigation with the other party, he cannot later renew that duel. In this sense, res judicata is usually and more accurately referred to as estoppel by judgment, or collateral estoppel. See Restatement of the Law of Judgments, §§68, 69, 70; Scott, "Collateral Estoppel by Judgment," 56 Harv. L. Rev. 1.

These same concepts are applicable in the federal income tax field. Income taxes are levied on an annual basis. Each year is the origin of a new liability and of a separate cause of action. Thus if a claim of liability or non-liability relating to a particular tax year is litigated, a judgment on the merits is res judicata as to any subsequent proceeding involving the same claim and the same tax year. But if the later proceeding is concerned with a similar or unlike claim relating to a different tax year, the prior judgment acts as a collateral estoppel only as to those matters in the second proceeding which were actually presented and determined in the first suit. Collateral estoppel operates, in other words, to relieve the government and the taxpayer of "redundant litigation of the identical question of the statute's application to the taxpayer's status." Tait v. Western Md. R. Co., 289 U.S. 620, 624.

But collateral estoppel is a doctrine capable of being applied so as to avoid an undue disparity in the impact of income tax liability. A taxpayer may secure a judicial determination of a particular tax matter, a matter which may recur without substantial variation for some years thereafter. But a subsequent modification of the significant facts or a change or development in the controlling legal principles may make that determination obsolete or erroneous, at least for future purposes. If such a determination is then perpetuated each succeeding year as to the taxpayer involved in the original litigation, he is accorded a tax treatment different from that given to other taxpayers of the same class. As a result, there are inequalities in the administration of the revenue laws, discriminatory distinctions in tax liability, and a fertile basis for litigious confusion. Compare United States v. Stone & Downer Co., 274 U.S. 225, 235, 236. Such consequences, however, are neither necessitated nor justified by the principle of collateral estoppel. That principle is designed to prevent repetitious lawsuits over matters which have once been decided and which have remained substantially static, factually and legally. It is not meant to create vested rights in decisions that have

become obsolete or erroneous with time, thereby causing inequities among taxpayers.

And so where two cases involve income taxes in different taxable years, collateral estoppel must be used with its limitations carefully in mind so as to avoid injustice. It must be confined to situations where the matter raised in the second suit is identical in all respects with that decided in the first proceeding and where the controlling facts and applicable legal rules remain unchanged. Tait v. Western Md. R. Co., supra. If the legal matters determined in the earlier case differ from those raised in the second case, collateral estoppel has no bearing on the situation. See Travelers Ins. Co. v. Commissioner, 2 Cir., 161 F.2d 93. And where the situation is vitally altered between the time of the first judgment and the second, the prior determination is not conclusive. See State Farm Ins. Co. v. Duel, 324 U.S. 154, 162; Freeman on Judgments, 5th Ed. 1925, §713. As demonstrated by Blair v. Commissioner, 300 U.S. 5, 9, a judicial declaration intervening between the two proceedings may so change the legal atmosphere as to render the rule of collateral estoppel inapplicable. But the intervening decision need not necessarily be that of a state court, as it was in the *Blair* case. While such a state court decision may be considered as having changed the facts for federal tax litigation purposes, a modification or growth in legal principles as enunciated in intervening decisions of this Court may also effect a significant change in the situation. Tax inequality can result as readily from neglecting legal modulations by this Court as from disregarding factual changes wrought by state courts. In either event, the supervening decision cannot justly be ignored by blind reliance upon the rule of collateral estoppel. . . . It naturally follows that an interposed alteration in the pertinent statutory provisions or Treasury regulations can make the use of that rule unwarranted. Tait v. Western Md. R. Co., supra, 625 of 289 U.S.

Of course, where a question of fact essential to the judgment is actually litigated and determined in the first tax proceeding, the parties are bound by that determination in a subsequent proceeding even though the cause of action is different. See Evergreens v. Nunan, 2 Cir., 141 F.2d 927. And if the very same facts and no others are involved in the second case, a case relating to a different tax year, the prior judgment will be conclusive as to the same legal issues which appear, assuming no intervening doctrinal change. But if the relevant facts in the two cases are separable, even though they be similar or identical, collateral estoppel does not govern the legal issues which recur in the second case. Thus the second proceeding may involve an instrument or transaction identical with, but in a form separable from, the one dealt with in the first proceeding. In that situation, a court is free in the second proceeding to make an independent examination of the legal matters at issue. It may then reach a different result or, if consistency in decision is considered just and desirable, reliance may be placed upon the ordinary rule of stare decisis. Before a party can invoke the collateral estoppel doctrine in these circumstances, the legal matter raised in the second proceeding must involve the same set of events or documents and the same bundle of legal principles that contributed to the rendering of the first judgment. Tait v. Western Maryland R. Co., supra. And see Griswold, "Res Judicata in Federal Tax Cases," 46 Yale L.J. 1320; Paul and Zimet, "Res Judicata in Federal Taxation," appearing in Paul, Selected Studies in Federal Taxation, 2d series, 1938, p. 104.

It is readily apparent in this case that the royalty payments growing out of the license contracts which were not involved in the earlier action before the Board of Tax Appeals and which concerned different tax years are free from the effects of the collateral estoppel doctrine. That is true even though those contracts are identical in all important respects with the 1928 contract, the only one that was

before the Board, and even though the issue as to those contracts is the same as that raised by the 1928 contract. For income tax purposes, what is decided as to one contract is not conclusive as to any other contract which is not then in issue, however similar or identical it may be. In this respect, the instant case thus differs vitally from Tait v. Western Md. R. Co., supra, where the two proceedings involved the same instruments and the same surrounding facts.

A more difficult problem is posed as to the $4,881.35 in royalties paid to the taxpayer's wife in 1937 under the 1928 contract. Here there is complete identity of facts, issues and parties as between the earlier Board proceeding and the instant one. The Commissioner claims, however, that legal principles developed in various intervening decisions of this Court have made plain the error of the Board's conclusion in the earlier proceeding, thus creating a situation like that involved in Blair v. Commissioner, supra. This change in the legal picture is said to have been brought about by such cases as Helvering v. Clifford; Helvering v. Horst; Harrison v. Schaffner . . . It must therefore be determined whether this *Clifford-Horst* line of cases represents an intervening legal development which is pertinent to the problem raised by the assignment of the 1928 agreement and which makes manifest the error of the result reached in 1935 by the Board. If that is the situation, the doctrine of collateral estoppel becomes inapplicable. . . .

[After reviewing the *Clifford-Horst* line of cases, the Court concluded:]

The principles which have thus been recognized and developed by the *Clifford* and *Horst* cases, and those following them, are directly applicable to the transfer of patent license contracts between members of the same family. They are guide-posts for those who seek to determine in a particular instance whether such an assignor retains sufficient control over the assigned contracts or over the receipt of income by the assignee to make it fair to impose income tax liability on him.

Moreover, the clarification and growth of these principles through the *Clifford-Horst* line of cases constitute, in our opinion, a sufficient change in the legal climate to render inapplicable in the instant proceeding, the doctrine of collateral estoppel relative to the assignment of the 1928 contract. True, these cases did not originate the concept that an assignor is taxable if he retains control over the assigned property or power to defeat the receipt of income by the assignee. But they gave much added emphasis and substance to that concept, making it more suited to meet the "attenuated subtleties" created by taxpayers. So substantial was the amplification of this concept as to justify a reconsideration of earlier Tax Court decisions reached without the benefit of the expanded notions, decisions which are now sought to be perpetuated regardless of their present correctness. Thus in the earlier litigation in 1935, the Board of Tax Appeals was unable to bring to bear on the assignment of the 1928 contract the full breadth of the ideas enunciated in the *Clifford-Horst* series of cases. And, as we shall see, a proper application of the principles as there developed might well have produced a different result, such as was reached by the Tax Court in this case in regard to the assignments of the other contracts. Under those circumstances collateral estoppel should not have been used by the Tax Court in the instant proceeding to perpetuate the 1935 viewpoint of the assignment. . . .

The judgment below must therefore be reversed and the case remanded for such further proceedings as may be necessary in light of this opinion.

Reversed.

Mr. Justice FRANKFURTER and Mr. Justice JACKSON believe the judgment of the Tax Court is based on substantial evidence and is consistent with the law, and would affirm that judgment for reasons stated in Dobson v. Commissioner, 320 U.S. 489, and Commissioner v. Scottish American Co., 323 U.S. 119.

NOTE

1. *Other applications of Sunnen.* Lynch v. Commissioner, 20 T.C. 1052 (1953), involved the validity of a family partnership for the years 1944 and 1945. In 1941 the Tax Court had held that the same partnership was valid in a proceeding based on a deficiency determined for the year 1937. The court held in the second proceeding that the *Tower* and *Culbertson* cases, supra page 388, had rendered "obsolete the legal concept" upon which its earlier decision had been based, so that neither res judicata nor collateral estoppel was applicable. Four dissenting judges took the position that the earlier proceeding had found *as a fact* that the petitioner had made a valid gift of capital interests in the business to his children and that the parties in good faith intended to carry on the business as partners, and that *Sunnen* was inapplicable. See also Massaglia v. Commissioner, 286 F.2d 258 (10th Cir. 1961) (change of state law); United States v. International Bldg. Co., 345 U.S. 502 (1953) (consent judgment in Tax Court on basis of depreciable property; held, does not give rise to estoppel by judgment for another year).

2. *References.* Branscomb, Collateral Estoppel in Tax Cases: Static and Separable Facts, 37 Texas L. Rev. 584 (1959); Sellin, The Sunnen Case — A Logical Terminus to the "Issue" of Res Judicata in Tax Cases, 4 Tax L. Rev. 363 (1949).

SECTION D. INTEREST AND CIVIL PENALTIES

1. *Interest*

Section 6601 of the 1954 Code, relating to interest on deficiencies, is based, with some modifications, on §292 of the 1954 Code.

PRIESS v. UNITED STATES

42 F. Supp. 89 (E.D. Wash. 1941)

SCHWELLENBACH, District Judge.

In this action plaintiff asks judgment for the amount of interest paid by him under protest on the deficiency assessments levied against him on his income taxes for the years 1936-1939 inclusive. The facts are not in dispute. In paintiff's returns during each of these years he reported as income on his single premium life insurance annuities, with death benefit contract, 3% of the consideration paid for the annuity part of the insurance policies. These returns were made in conformity with the interpretation placed upon the Statute by the Internal Revenue Bureau (General Counsel Memorandum 6395). Thereafter, on January 8, 1940, defendant, through its Internal Revenue Bureau, adopted a new interpretation of Section 22(b)(2) of the Revenue Act of 1936 (General Counsel Memorandum 21716). Under this interpretation it was held that such single premium life insurance annuities, with death benefit contracts, were not annuity contracts but contracts for the payment of the interest or earnings on a certain fund. Under the new interpretation, plaintiff's income for tax purposes during each of the years mentioned was substantially increased. Thereafter, a deficiency assessment was imposed [§6211]. Included in such a deficiency as a part of the tax was interest at the rate of 6% per annum from the date prescribed for the payment of the tax to the date the deficiency was assessed. [§6601(a).] Plaintiff paid the principal of the deficiency without objection but he paid the interest portion of the deficiency under protest and this action is to compel the refunding of such interest.

It is conceded that, in making his returns and in paying his taxes during the period mentioned, plaintiff complied fully with the requirements of the defendant

and the defendant's interpretation of the Statute. Plaintiff's theory in this case is that, as to him, the collection of interest constituted a penalty. He makes this contention on the basis that he neither borrows nor lends money. He has retired from business. All of his funds are invested. He spends his income for personal living expenses, traveling expenses and donations to charity. He, therefore, argues that the retention of the money which he should have paid during each of the involved years was of no value to him and that, therefore, he should not be penalized by being compelled to pay for the use of it since he was without fault.

To this contention, defendant answers that this Court has no authority to render judgment on recovery of either taxes or interest collected in pursuance of an Act of Congress enacted in pursuance of its constitutional authority. Jackson Furniture Company v. McLaughlin, 9 Cir., 85 F.2d 606; United States v. Globe Indemnity Company, 2 Cir., 94 F.2d 576.

To my mind, this is a complete answer. The Statute is plain and unambiguous. . . .

Clearly, in the light of the Statute and the ruling of the Circuit Court of Appeals of the Ninth Circuit, Jackson Furniture Company v. McLaughlin, supra, it does not lie within my power to undo the action of the Commissioner in which he was following the plain, simple mandate of the Statute.

However, plaintiff makes a forceful and an appealing argument on the basis that he is being penalized when he was in fact innocent of wrongdoing. So forcible and so appealing is plaintiff's argument that I feel constrained to examine closely the question as to whether this is a penalty.

It is evident that the Congress, in providing interest on deficiency assessments, did not consider such interest to be a penalty. This is shown by the fact that, in two separate sections of the Act apart from the interest on deficiency section, the Congress provided for penalties. In [§6651(a)], there is provided the penalty for failure to file a return. In [§6653(a)], there are provided penalties for deficiencies due to negligence or intentional disregard of rules and regulations and for deficiencies due to fraud with intent to evade the tax. The legislative intent to distinguish between penalty and interest is clear.

Plaintiff, in his brief, states that he has been unable to find any cases dealing directly with this question. There are a number of cases which, on careful analysis, will be seen to deal with precisely the same question raised by the plaintiff here. These are cases involving the bankruptcy statute, 11 U.S.C.A. §93, subd j, which prohibits the allowance of debts to the United States or any state or subdivision thereof as a penalty or forfeiture. These cases involved the question of interest provisions in taxing statutes where the rate of interest was in excess of the legal rate allowed by the statutes of the state where the taxpayer lived. It was the contention in those cases that, since the legislature of the state had determined that money in that particular state was worth only a certain percent of interest for its use, that any taxing statute which required the payment of more than the statutory interest rate was not interest but was a penalty and, therefore, not allowable as a credit in the bankruptcy court. We should remember, at this point, that plaintiff contends that the use of the money was of no value to him and, therefore any charge for its use should be classed not as interest but as a penalty. Keeping this argument in mind, the pertinency of the bankruptcy cases is apparent. A number of the District Courts have upheld plaintiff's contention and have reduced the allowances to the amount of the statutory interest rate. . . .

However, in the case of Unemployment Reserves Commission of California v. Meilink, 116 F.2d 330, the Circuit Court of Appeals for the Ninth Circuit just a year ago passed upon this question fully and squarely. It based its decision on the decision of the Supreme Court of the United States in the case of United States v.

Childs, 266 U.S. 304. It quotes at length from the opinion in the *Childs* case. Included in such quotations are the following:

> Besides, the federal statute is precise, and it is made peremptory by the distinction between "penalty" and "interest," and if it may be conceded that the use of the latter word would not save it from condemnation if it were in effect the former, it cannot be conceded that 1 per cent. per month — 12 per cent. a year — gives it that illegal effect, certainly not against legislative declaration that is within the legislative power, there being no ambiguity to resolve. . . . The tax in this case is one on income; a burden imposed for the support of the government. Interest is put upon it and so denominated, distinguished from the 5 per cent. as penalty, clearly intended to compensate the delay in payment of the tax — the detriment of its nonpayment, to be continued during the time of its nonpayment — compensation, not punishment.

In his very carefully considered opinion in the *Unemployment Reserves Commission* case, Judge Wilbur reviews the decisions on the question in the various circuit courts of appeals and points out that only one circuit is at variance with the rule enunciated in United States v. Childs, supra. There can be no doubt but that the decision in this case must be controlled by the decision of the Supreme Court in United States v. Childs, supra, and of the Circuit Court of Appeals in Unemployment Reserves Commission of California v. Meilink, supra.

In the conclusion of his brief, plaintiff appeals strongly upon the basis of justice and fairness and, in effect, asks me to disregard the provision of the Statute. The answer to that argument is that if assessment of interest charge against this plaintiff is unfair, it is because he occupies a position which is occupied by such a small percentage of our population that Congress could not be expected to legislate specially for them. The number of persons in plaintiff's position for whom the use of money is of no value is negligible. Furthermore, the point which plaintiff overlooks is that interest is charged not only because of the value to the one who uses it but also as compensation to the one who has been deprived of the use of it.

The action must be dismissed.

NOTE

References. McDowell, Interest Problems in Underpayments and Overpayments of Tax, 19 N.Y.U. Inst. on Fed. Taxation 1403 (1961); Webster, Interest on Deficiencies and Inchoate Deficiencies, 8 Tax L. Rev. 481 (1953).

2. *Addition for Late Filing or Failing to File*

Section 6651(a) of the 1954 Code, imposing a 25 per cent penalty for failure to file a return on the due date, is similar to §291(a) of the 1939 Code.

HAYWOOD LUMBER & MINING CO. v. COMMISSIONER

178 F.2d 769 (2d Cir. 1950)

SWAN, Circuit Judge.

The taxpayer is a personal holding company. The Commissioner determined deficiencies in personal holding company surtaxes for the years 1941 and 1942 and added thereto a 25 percent penalty, pursuant to [§6651(a)], for petitioner's failure to file personal holding company returns for those years.* The sole question presented to the Tax Court and likewise here is whether the taxpayer's failure to file personal holding company returns for the years in suit was "due to reason-

* A separate personal holding company return is no longer required. 1954 Code, §6501(f). — ED.

able cause and not due to willful neglect." [§6651(a).] The Tax Court held that it was not due to reasonable cause.

"Reasonable cause" has been defined by the Regulations to mean that the taxpayer exercised ordinary business care and prudence. [§301.6651-1(a)(3).] In the case at bar Mr. Sprague, the taxpayer's secretary-treasurer, requested a certified public accountant, Mr. Wolcott, who was competent to advise on tax matters, to prepare the proper corporate tax returns for the years 1941 and 1942. Sprague fully disclosed to Wolcott all necessary information about the corporation and Wolcott knew that the taxpayer was a personal holding company but "through inadvertence" did not inform Sprague of this fact nor submit to him a personal holding company surtax return. Sprague was aware of the personal holding company surtax statute but he had never studied its application and it did not occur to him that the petitioner was a personal holding company. He filed on behalf of the corporation only the returns prepared by Wolcott. Because Sprague did not "specifically inquire" of Wolcott "concerning the personal holding company status of petitioner" but "merely awaited passively for such tax advice as Wolcott might volunteer to give," the Tax Court held, one judge dissenting, that petitioner had not sustained the burden of proving that ordinary business care and prudence were exercised in failing to file the personal holding company surtax returns.

With this conclusion we disagree. When a corporate taxpayer selects a competent tax expert, supplies him with all necessary information, and requests him to prepare proper tax returns, we think the taxpayer has done all that ordinary business care and prudence can reasonably demand. Sprague had not "awaited passively for such tax advice" as Wolcott "might volunteer to give"; he affirmatively requested the preparation by his consultant of proper returns.[1] To require Mr. Sprague to inquire specifically about the personal holding company act nullifies the very purpose of consulting an expert. We doubt if anyone would suggest that a client who stated the facts of his case to his lawyer must, in order to show ordinary business care and prudence, inquire specifically about the applicability of various legal principles which may be relevant to the facts stated. The courts have recognized that reliance on the advice of counsel or of expert accountants, sought and received in good faith is "reasonable cause" for failing to file a tax return. We think those cases are correctly decided and in principle control the case at bar. The Tax Court relies on Hermax Co. v. Commissioner, 3 Cir., 175 F.2d 776, affirming 11 T.C. 442. There the accountant was not qualified to advise about tax matters and the corporation's president testified to no reason why he relied on him. Here the undisputed evidence showed that Wolcott had had over twenty years of extensive tax experience with a prominent accounting firm in Binghamton and had advised the petitioner on tax matters in previous years.

The respondent contends that where all responsibility for the preparation of tax returns is delegated to an agent, the taxpayer should be held to accept its agent's efforts cum onere and be chargeable with his negligence. That was the rationale suggested by this court in Berlin v. Commissioner, 59 F.2d 996, certiorari denied 287 U.S. 642. Further reflection convinces us that that proposition is not sound. The standard of care imposed by [§6651(a)] is personal to the taxpayer. To impute to the taxpayer the mistakes of his consultant would be to penalize him for consulting an expert; for if he must take the benefit of his counsel's or accountant's advice cum onere, then he must be held to a standard of care which is not his own and one which, in most cases, would be far higher than that exacted

1 Mr. Sprague testified as to his conversation with Mr. Wolcott: "I advised him, 'Here are the Hayward figures' — I had brought my books with me — 'if there have been any changes in the law we don't know about, you tell us and prepare the return.' "

of a layman. The cases which hold that advice sought and received in good faith from a competent adviser constitutes reasonable cause for failure to file the required return are inconsistent with the cum onere doctrine suggested in the *Berlin* case.

In Paymer v. Commissioner, 2 Cir., 150 F.2d 334, 337 we said that reasonable cause was a question of fact and "therefore presents no reviewable issue." This abbreviated statement does not state the whole principle, which is better expounded in Hatfried, Inc. v. Commissioner, 3 Cir., 162 F.2d 628, 635. As there pointed out, whether the elements which constitute "reasonable cause" are present is a question of fact, but what elements must be present to constitute "reasonable cause" is a question of law. The Tax Court erred in our opinion upon this question of law. Accordingly the decision must be modified to strike out the penalties in personal holding company surtax for the years 1941 and 1942 in the respective amounts of $567.77 and $923.83.

NOTE

1. *Expert advice as "reasonable cause."* What if the taxpayer goes to an expert and answers all questions accurately, but does not volunteer essential data because he does not understand its significance? See Tarbox Corp. v. Commissioner, 6 T.C. 35 (1946); Genesee Valley Gas Co. v. Commissioner, 180 F.2d 41 (D.C. Cir. 1950). In Commissioner v. American Assn. of Engineers Employment, Inc., 204 F.2d 19 (7th Cir. 1953), the taxpayer proved that it failed to file returns because an attorney with wide experience in federal taxation had advised in writing that it was an exempt organization. The opinion was not in evidence, nor did the taxpayer establish what information had been furnished to the attorney as a basis for his opinion. The Tax Court held that reasonable cause for the failure to file was shown, and the Court of Appeals affirmed, saying:

> The Tax Court could also assume that a reputable and experienced attorney who had a wide practice in the tax field, would not render an opinion, either written or verbal, on the question of the liability of a client for federal taxes without being in possession of the facts necessary to determine that question. [204 F.2d at 21.]

Note that an attorney might render an opinion on the basis of information furnished to him by a client without making an independent investigation, and the facts assumed by him might not be correct. What of advice from officials of the Internal Revenue Service?

Note that §6651(a) requires the taxpayer not only to negate "willful neglect" but also to show that his delinquency was due to "reasonable cause." In Rogers Hornsby v. Commissioner, 26 B.T.A. 591 (1932), the 25 per cent addition was imposed where the taxpayer prepared and executed the return before the due date, leaving it with his wife when he left for spring training to file on March 15, and she through forgetfulness filed it two months late: "The penalty may be avoided only if the tardy filing was due to a reasonable cause and not to willful neglect. Both conditions must exist. Here the only excuse is that one of the petitioners forgot to file them. This can scarcely be said to be a 'reasonable cause' for failing to perform such an important act."

For a comprehensive review of the cases, see Stevens Bros. Foundation, Inc. v. Commissioner, 39 T.C. 93 (1962).

2. *Meaning of "return."* What is a "return?" See O'Sullivan Rubber Co. v. Commissioner, 120 F.2d 845; Commissioner v. Lane-Wells Co., 321 U.S. 219 (1944). In Germantown Trust Co. v. Commissioner, 309 U.S. 304 (1940), the taxpayer filed the tax return prescribed for trusts, though it should have filed a corporate return because it was an "association" under §7701(a)(3). The form that was filed, however, supplied "all information necessary to the calculation of any tax which might be due." The Court held that this was a "return" so as to set the statute of limitations running. In Sanders v. Commissioner, 225 F.2d 629 (10th Cir. 1955), the penalty for failure to file a return was imposed, although the taxpayer filed "skeleton" returns containing his name and

address and the amount of tax due, but "no detailed information as to income or deductions." What of a gambler who reports $25,000 of income from "various sources," giving no other details except his name, address, marital status, and tax due? Supra page 117.

3. *References.* Lewis, What Is Competent Tax Advice, 28 Taxes 33 (1950); Dendy, How Effectively Can a Taxpayer Hide Behind His Adviser; What Is a Qualified Adviser, 10 N.Y.U. Inst. on Fed. Taxation 723 (1952); Gordon, Income Tax Penalties, 5 Tax L. Rev. 121, 167-180 (1950).

3. *Addition for Negligence*

Section 6653(a) of the 1954 Code, imposing a 5 per cent penalty for negligence or intentional disregard of rules and regulations, is similar to §293(a) of the 1939 Code.

RUSHING v. COMMISSIONER

¶52,117 P-H Memo T.C. (1952), aff'd, 214 F.2d 383 (5th Cir. 1954)

JOHNSON, Judge:

This proceeding involves deficiencies in income tax and penalties for the calendar years 1946, 1947 and 1948. . . .

FINDINGS OF FACT

Petitioner was in the oil field contracting business. His work consisted of servicing wells, constructing derricks, setting units, swabbing wells, pulling rods and tubing, and general construction work in the oil field. He employed from 10 to 40 people in this work.

Petitioner in each of the taxable years kept no formal books and records. His income tax returns were prepared by an accountant from information furnished by the taxpayer. The source of this information was cancelled checks and bank statements. Petitioner did not maintain separate bank accounts for his business or personal needs.

Prior to the preparation of his income tax returns, he grouped his checks in certain categories of expenses, such as travel, entertainment and repairs, and obtained total amounts therefrom. During the conferences with the internal revenue agent, petitioner regrouped these checks into other categories and obtained new totals. Later, at the hearing, he regrouped these checks for the third time and thus established the third set of expense figures. In each group of checks presented at the hearing allegedly representing expenses for travel, advertising and entertainment, there were checks made payable to cash, individuals, restaurants, liquor stores, drug stores, grocery stores, and clothing stores. Only in general terms and from his memory was petitioner able to give the number and names of persons entertained and the amounts of alleged expenses for gifts and advertising. . . .

OPINION

Petitioner, a taxpayer without legal knowledge or experience, was not represented by counsel in this proceeding. Before the hearing began, the court suggested to the petitioner that due to the large sum of money involved, the rules governing the admission of evidence, and the Court's inability to try the case for him, it might be advisable for him to be represented by counsel. The Court offered to delay the hearing, if the petitioner so desired, so that counsel might be obtained. The petitioner declined the offer and proceeded to try the case himself.

From the record it is evident that petitioner did not prepare his case; nor did

he present evidence by which we might determine the validity of his claims concerning his expenses. Aside from petitioner's testimony, which fails to substantiate his contentions, he only presented four exhibits. Each exhibit consisted of an envelope containing cancelled checks. Exhibit No. 1, entitled "1946 Travel $3,079.45," contains some 62 cancelled checks. Exhibit No. 2, entitled "Travel, Entertainment & Advertising -8-[1948] $3,768.83," contains 99 cancelled checks. Exhibit No. 3, entitled "Entertainment & Adv. $1,917.50," contains 62 cancelled checks. Exhibit No. 4, entitled "1946 Materials & Supplys [*sic*] $18,239.94," contains some 131 cancelled checks. As stated in the facts, each group of checks was made payable to various persons and business establishments. Petitioner admitted that some portion could have been used for personal expenses. He was unable, except in a general way, to account for any of these expenses.

We have carefully examined the checks and from them alone we can not allocate the expenses to the various expense accounts as suggested by the petitioner. Moreover, we can not adopt petitioner's contentions as to the total amounts expended for travel, advertising, entertainment, depreciation, repairs, materials and supplies, and office expenses. The adjustments as determined by the respondent must be sustained. . . .

Petitioner also alleges error in respondent's determination of penalties under [§6653(a)]. In regard to the negligence penalty under [§6653(a)], a finding that the return is incorrect, or that the taxpayer did not keep proper or complete records or that his calculations are confusing, is not enough to warrant the imposition of the penalty. Bennett v. Commissioner, 139 F.2d 961 affirming Memorandum Opinion of the Tax Court. We can not find on this record that petitioner intentionally disregarded the rules and regulations of the Commissioner. While petitioner's bookkeeping methods would seem to be open to a certain amount of criticism, this falls short of an intentional disregard of the regulations. The respondent's determination on this point is disapproved.

NOTE

1. *The penalty for negligence.* It would be a rash taxpayer who modeled his behavior on that of the petitioner in this case. In other cases, unsubstantiated or baseless estimates have been regarded as "negligence" and a failure to keep adequate records as "intentional disregard of rules and regulations" under [§6653(a)]. See the last paragraph of the *Bechelli* case, supra page 891. Are the Regulations prescribing the records to be kept, Regs. §1.6001-1(a), so vague that they cannot be "intentionally disregarded" except by a failure to keep any records at all? Are cancelled cehcks, bank statements, and a list of cash receipts and disbursements sufficient for a cash basis taxpayer? Are receipts, for payments in cash and/or by check, necessary? Are invoices essential? Must a person whose only income is a salary and who uses the optional standard deduction keep any records?

See Fischer v. United States, 212 F.2d 441 (10th Cir. 1954), involving a taxpayer who had written and published a booklet entitled "Mind Your Own Business," including among other things a recommended method for keeping records to avoid income tax difficulties. The booklet was held admissible in evidence, in a trial of the taxpayer for tax evasion, to prove willfulness on his part in understating income. Apparently he had relied on a lack of records to establish that his omissions were innocent.

2. *Negligence penalty and penalty for late filing or failure to file: cumulative.* The 5 per cent penalty for negligence may be imposed in addition to the 25 per cent penalty for failure to file or for a late filing. For an example, see Chimchirian v. Commissioner, 42 B.T.A. 1437, 1442 (1940), aff'd per curiam, 125 F.2d 746 (D.C. Cir. 1942).

3. *Declarations of estimated tax.* The rather complex pre-1954 rules on penalties for failure to file declarations of estimated tax and for substantial underestimates were eliminated by the 1954 Code, which substituted a 6 per cent addition to any "underpay-

ment" (as defined). §§6654 and 6655. In Commissioner v. Acker, 361 U.S. 87 (1959), the Supreme Court belatedly held that under the pre-1954 law the government was not entitled to impose both a penalty for failure to file a declaration of estimated tax and a penalty for a substantial underestimate (on the theory of a zero estimate). But two penalties were payable (pre-1954 Code) if the taxpayer filed a late estimate that was also too low. Stellor v. United States, 287 F.2d 588 (Ct. Cl. 1961).

4. *References.* Gordon, Income Tax Penalties, 5 Tax L. Rev. 121 (1950); Smith, What Are Adequate Records for the Preparation of Income Tax Returns, 11 N.Y.U. Inst. on Fed. Taxation 1235 (1953); Stanley, Penalties for Under-Estimating Personal Income Taxes, 1959 So. Calif. Tax Inst. 437.

JOURNAL CO. v. COMMISSIONER

46 B.T.A. 841 (1942)

[Under the Revenue Act of 1938, a corporation could credit against a so-called "tentative tax" $2\frac{1}{2}$ per cent of its "dividends paid credit," which included inter alia amounts paid to retire certain indebtedness. The regulations promulgated under this Act, however, provided that amounts paid to retire indebtedness that had been deducted or credited in computing the undistributed profits tax imposed by the Revenue Act of 1936 could not be credited a second time as part of the "dividends paid credit" of the 1938 Act. The taxpayer paid out certain amounts to retire indebtedness and was advised by counsel that although a credit therefor was denied by the Regulations, the Regulations were contrary to the statute and invalid. Accordingly, the taxpayer took the credit. The Commissioner asserted a deficiency, and added the 5 per cent penalty of [§6653(a)] on the ground that there had been an "intentional disregard of rules and regulations."

[After holding that the Regulation was valid and that the deficiency was properly asserted, the Board of Tax Appeals went on to consider the 5 per cent penalty:]

ARNOLD: . . . The second issue, affirmatively raised in the answer, is whether any part of the deficiency is due to petitioner's negligence, or intentional disregard of respondent's rules and regulations as provided in [§6653(a)]. Respondent rests his argument, not on any alleged negligence of the petitioner, but upon an alleged intentional disregard of rules and regulations. . . .

The issue turns upon the construction of the statutory phrase "intentional disregard of rules and regulations." The stipulated facts show that petitioner was fully cognizant of the statutory provisions [re "dividends paid credit"] and of respondent's interpretation thereof. Petitioner sought the advice of counsel as to what it should do under the circumstances then existing. Counsel advised that petitioner was entitled to the credit provided by [the statute] and that respondent's regulation was an invalid interpretation of the statute. Petitioner then had to decide which of two opposite constructions it would follow in making and filing its return. The stipulated facts indicate that petitioner gave careful consideration to the problem before electing to follow the advice of counsel. Its choice was made deliberately, with full knowledge that the administrative interpretation was contrariwise. Obviously, therefore, petitioner intentionally disregarded respondent's regulation.

The defense advanced is in the nature of confession and avoidance. Petitioner stipulates that it acted with knowledge but upon advice of counsel and directs attention to the division of opinion on this Board in Spokane Dry Goods Co. [43 B.T.A. 793] as proof of the soundness of its action and as justification for its belief that the respondent's regulation was invalid. Be that as it may, the statute speaks in mandatory language when it states that if

[any part of any underpayment . . . is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to 5 per cent of the underpayment.]

As hereinbefore demonstrated, petitioner *did* intentionally disregard the regulations, and, since this conclusion is inescapable under the stipulated facts, it is mandatory that the 5 percent addition be assessed, collected, and paid. . . .

We have examined the authorities cited without finding one dispositive of this issue. In Frank T. Heffelfinger, 32 B.T.A. 1232; affirmed on another point, 87 F.(2d) 991, we found as a fact that there was no intentional disregard of rules and regulations. Clearly the stipulated facts are susceptible of no such ultimate finding in this proceeding. Most of the cases cited dealt with the 5 percent addition for negligence. In the few cases where "intentional disregard of rules and regulations" was considered, the opinions coupled negligence with intentional disregard, see Lucian T. Wilcox, 44 B.T.A. 373; Gibbs & Hudson, Inc., 35 B.T.A. 205; and Oscar G. Joseph, 32 B.T.A. 1192. Negligence has neither been urged nor established in this proceeding, so none of the latter cases involved comparable situations.

Harsh though the conclusion may seem, the stipulated facts herein leave no recourse but to grant respondent's request for a 5 percent addition to the deficiency.

Decision will be entered under Rule 50.

NOTE

1. *Intentional disregard of rules and regulations.* This decision was reversed, 134 F.2d 165 (7th Cir. 1943), because the Supreme Court in the meantime had invalidated the challenged Regulation. Helvering v. Sabine Transportation Co., 318 U.S. 306 (1943). Is this the kind of "intentional disregard of rules and regulations" that should be penalized? Note that the effect of imposing the penalty in this kind of case is to place a premium on paying the tax in a doubtful case and suing for refund in the District Court or the Court of Claims. May the penalty be imposed if a deficiency is caused by an intentional challenge of the validity of a *statute,* if no rules and regulations have been promulgated? Does the term "rules" embrace every publicly announced Service ruling and interpretation?

The Senate version of the 1954 Code proposed to overrule this decision "if the taxpayer has reasonable grounds for believing the rule or regulations to be invalid and if he attaches to his return a statement sufficient to apprise" the government of his "grounds for believing them invalid." The provision was eliminated by the conference committee, no reasons being given.

2. *Test cases.* See Kellems v. United States, 97 F. Supp. 681 (D. Conn. 1951), involving a publicly announced refusal to comply with the income tax withholding provisions in order to test their constitutionality. The court imposed a penalty because the taxpayer did not consult an attorney before violating the Act and, so far as the record showed, did not even try to ascertain whether the constitutionality of the provisions had already been judicially sustained. The court's decision was in a refund action against the United States; in other counts, where the Collector of Internal Revenue was the defendant, a jury trial was had and it did not impose the penalty. The statute in question (§2707(a) of the 1939 Code, made applicable to the withholding of taxes by §§1627 and 1430 of the 1939 Code) was somewhat different from §6653(a), in that the penalty was imposed on any person "who willfully fails to . . . collect . . . and pay over the tax."

3. *Reference.* Hoffman, Intentional Disregard of Rules and Regulations, 28 Taxes 111 (1950).

Section E. Fraud Penalties and Prosecutions

1. *Civil Fraud*

Section 6653(b) of the 1954 Code, imposing a 50 per cent penalty for fraud, is based on §293(b) of the 1939 Code.

HELVERING v. MITCHELL

303 U.S. 391 (1938)

Mr. Justice Brandeis delivered the opinion of the court. . . .

The question for decision is whether assessment [of the 50 per cent fraud penalty, §6653(b)] is barred by the acquittal of the defendant on an indictment under [§7201] for a willful attempt to evade and defeat the tax.

The Commissioner of Internal Revenue found that Charles E. Mitchell of New York had, in his income tax return for the year 1929, fraudulently deducted from admitted gross income an alleged loss of $2,872,305.50 from a purported sale of 18,300 shares of National City Bank stock to his wife; that he had fraudulently failed to return the sum of $666,666.67 received by him as a distribution from the management fund of the National City Company, of which he was chairman; and that these fraudulent acts were done with intent to evade the tax. On December 8, 1933, the Commissioner notified Mitchell that there was a deficiency in his tax return of $728,709.84 and, on account of the fraud, a 50 per cent addition thereto in the sum of $364,354.92.

Mitchell appealed to the Board of Tax Appeals, which sustained the Commissioner's determination. Mitchell v. Com'r, 32 B.T.A. 1093. Upon a petition for review, the Circuit Court of Appeals concluded that there was ample evidence to support the Board's findings that Mitchell had fraudulently made deduction of the loss and that he had fraudulently failed to return the amount received from the management fund; and that, despite the facts hereafter stated, the Board was free to find the facts according to the evidence. It accordingly affirmed the assessment of the deficiency of $728,709.84; but it reversed the Board's approval of the additional assessment of $364,354.92, because of the following facts:

Before the deficiency assessment was made Mitchell had been indicted in the federal court for Southern New York under [§7201], which provides:

> Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned not more than five years, or both, together with the costs of prosecution.

The first count charged that Mitchell "unlawfully, willfully, knowingly, feloniously, and fraudently did attempt to defeat and evade an income tax of, to wit, $728,709.84, upon his net income for 1929." He was tried on the indictment and acquitted on all counts. The item of $728,709.84 set out in the first count is the same item as that involved in the deficiency assessed; and both arose from the same transactions of Mitchell. But the addition of $364,354.92 by reason of fraud was not involved in the indictment.

The Circuit Court of Appeals held that the prior judgment of acquittal was not a bar under the doctrine of res judicata; and hence it affirmed the assessment of the $728,709.84. But it held that our decision in Coffey v. United States, 116 U.S. 436, and United States v. La Franca, 282 U.S. 568, required it "to treat the imposi-

tion of the penalty of 50 percent. *as barred by the prior acquittal of* Mitchell in the criminal action." Mitchell v. Com'r, 2 Cir., 89 F.2d 873, 878. Mitchell's petition for certiorari to review so much of the judgment as upheld the assessment of the deficiency of $728,709.84 was denied. The Commissioner's petition to review so much of the judgment as denied the 50 per centum in addition was granted, because of the importance in the administration of the revenue laws of the questions presented and alleged conflict in decisions.

First. Mitchell contends that the claim for the 50 per cent. is barred by the doctrine of res judicata. He asserts that all the facts and intents requisite to the imposition of the 50 per centum addition to the deficiency were put in issue and determined against the Government in the criminal trial, and that hence, under the doctrine of res judicata, the judgment of acquittal bars it from obtaining a second judgment based upon the same facts and intents. Since this proceeding to determine whether the amount claimed is payable as a tax is a proceeding different in its nature from the indictment for the crime of willfully attempting to evade the tax, the contention that the doctrine of estoppel by judgment applies rests wholly on the assertion that the issues here presented were litigated and determined in the criminal proceeding. Compare Tait v. Western Maryland Ry. Co., 289 U.S. 620.

The difference in degree of the burden of proof in criminal and civil cases precludes application of the doctrine of res judicata. The acquittal was "merely . . . an adjudication that the proof was not sufficient to overcome all reasonable doubt of the guilt of the accused." Lewis v. Frick, 233 U.S. 291, 302. It did not determine that Mitchell had not willfully attempted to evade the tax. That acquittal on a criminal charge is not a bar to a civil action by the Government, remedial in its nature arising out of the same facts on which the criminal proceeding was based has long been settled. . . . Where the objective of the subsequent action likewise is punishment, the acquittal is a bar, because to entertain the second proceeding for punishment would subject the defendant to double jeopardy; and double jeopardy is precluded by the Fifth Amendment whether the verdict was an acquittal or a conviction. Murphy v. United States, 272 U.S. 630.

The Government urges that application of the doctrine of res judicata is precluded also by the difference in the issues presented in the two cases; that although the indictment and this proceeding arise out of the same transactions and facts, the issues in them are not the same; that on the indictment the issue was whether Mitchell had "willfully" attempted to "evade or defeat" the tax; that whether he had done so "fraudulently" was not there an issue, . . . ; and that in this proceeding the issue is specifically whether the deficiency was "due to fraud." . . . Since there was not even an adjudication that Mitchell did not willfully attempt to evade or defeat the tax, it is not necessary to decide whether such an adjudication would be decisive also of this issue of fraud. Compare Hanby v. Commissioner, 4 Cir., 67 F.2d 125, 129.

Second. Mitchell contends that this proceeding is barred under the doctrine of double jeopardy because the 50 per centum addition of $364,354.92 is not a tax, but a criminal penalty intended as punishment for allegedly fraudulent acts. Unless this sanction was intended as punishment, so that the proceeding is essentially criminal, the double jeopardy clause provided for the defendant in criminal prosecutions is not applicable.

1. In assessing income taxes the Government relies primarily upon the disclosure by the taxpayer of the relevant facts. This disclosure it requires him to make in his annual return. To ensure full and honest disclosure, to discourage fraudulent attempts to evade the tax, Congress imposes sanctions. Such sanctions may confessedly be either criminal or civil. . . .

Congress may impose both a criminal and a civil sanction in respect to the same act or omission; for the double jeopardy clause prohibits merely punishing twice, or attempting a second time to punish criminally, for the same offense. The question for decision is thus whether [§6653 (b)] imposes a criminal sanction. That question is one of statutory construction. Compare Murphy v. United States, 272 U.S. 630, 632.

Remedial sanctions may be of varying types. One which is characteristically free of the punitive criminal element is revocation of a privilege voluntarily granted. Forfeiture of goods or their value and the payment of fixed or variable sums of money are other sanctions which have been recognized as enforceable by civil proceedings since the original revenue law of 1789. Act of July 31, 1789, c. 5, §36, 1 Stat. 29, 47. In spite of their comparative severity, such sanctions have been upheld against the contention that they are essentially criminal and subject to the procedural rules governing criminal prosecutions. . . .

2. The remedial character of sanctions imposing additions to a tax has been made clear by this Court in passing upon similar legislation. They are provided primarily as a safeguard for the protection of the revenue and to reimburse the Government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud. In Stockwell v. United States, 13 Wall. 531, 547, 551, 20 L. Ed. 491, the Court said of a provision which added double the value of the goods:

> It must therefore be considered as remedial, as providing indemnity for loss. And it is not the less so because the liability of the wrongdoer is measured by double the value of the goods received, concealed, or purchased, instead of their single value. The act of abstracting goods illegally imported, receiving, concealing, or buying them, interposes difficulties in the way of a government seizure, and impairs, therefore, the value of the government right. It is, then, hardly accurate to say that the only loss the government can sustain from concealing the goods liable to seizure is their single value, or to assert that the liability imposed by the statute of double the value is arbitrary and without reference to indemnification. Double the value may not be more than complete indemnity. . . .
>
> The act of 1823 was, as we have seen, remedial in its nature. Its purpose was to secure full compensation for interference with the rights of the United States.

3. In [§§6502(a) and 6659], it is provided that collection of the 50 per centum addition, like that of the primary tax itself, may be made "by distraint" as well as "by a proceeding in court." If the section provided a criminal sanction, the provision for collection by distraint would make it unconstitutional. . . . That Congress provided a distinctly civil procedure for the collection of the additional 50 per centum indicates clearly that it intended a civil, not a criminal, sanction. Civil procedure is incompatible with the accepted rules and constitutional guaranties governing the trial of criminal prosecutions, and where civil procedure is prescribed for the enforcement of remedial sanctions, those rules and guaranties do not apply. Thus the determination of the facts upon which liability is based may be by an administrative agency instead of a jury, or if the prescribed proceeding is in the form of a civil suit, a verdict may be directed against the defendant; there is no burden upon the Government to prove its case beyond a reasonable doubt, and it may appeal from an adverse decision; furthermore, the defendant has no constitutional right to be confronted with the witnesses against him, or to refuse to testify; and finally, in the civil enforcement of a remedial sanction there can be no double jeopardy. . . .

Reversed.

MR. JUSTICE MCREYNOLDS is of opinion that the judgment of the Circuit Court of Appeals should be affirmed.

MR. JUSTICE CARDOZO and MR. JUSTICE REED took no part in the consideration or decision of this case.

MITCHELL v. COMMISSIONER

118 F.2d 308 (5th Cir. 1941)

Before SIBLEY, HOLMES, and McCORD, Circuit Judges.

SIBLEY, Circuit Judge.

The Board of Tax Appeals adjudged that William E. Mitchell should pay additional income taxes for the year 1930, though barred, and a penalty of fifty percent additional, because of fraud in the tax return with intent to evade the tax. Mitchell petitions for review upon the grounds that the particular facts found by the Board do not in law authorize the conclusion of fraud with intent to evade tax, and that there was no evidence of fraud, but only of mistake and negligence.

The pleadings before the Board involved the taxes of five years, but the Board found in favor of Mitchell as to all save the year 1930. The allegations were at first general, but on Mitchell's motion for particulars the Commissioner amended by quoting the untrue items in the returns and stating the amount in dollars of the falsity, and concluded "(w) That the petitioner at the time of filing said federal income tax returns . . . knew the same to be false and nevertheless filed them with the intent that they should be accepted as true and correct." Mitchell replied by expressly admitting the incorrectness alleged, but as to (w) "Denies that the petitioner at the time of filing said federal income tax returns knew the same to be false; but admits the petitioner filed said returns with intent that they should be accepted as true and correct." The single issue therefore specifically drawn was whether Mitchell when he filed the 1930 return knew or did not know it was untrue.

The burden of proof was upon the Commissioner. Internal Revenue Code [§7454]; Griffiths v. Commissioner, 7 Cir., 50 F.2d 782. To sustain it he swore as witnesses Mitchell, and P. H. Nabors who had prepared the return. Mitchell denied positively and with indignation that he knew the return was in any respect untrue; he had no books of account, but turned his papers and files over to Nabors whom he regarded as reliable and competent, and accepted the returns he prepared for all the years in question without checking the computations or doubting their correctness. Nabors also testified positively that he alone prepared the return, and what mistakes were made were his own, that he had no request from Mitchell to distort facts and would not have done that if asked to; that the mistakes made were wholly unintended and unknown, and that Mitchell did not check his computations so far as he knew. The returns, all of which for the years in question were made out by Nabors, were really complicated and he made many mistakes in them both for and against Mitchell. Stocks of the corporations for which Mitchell was working had been bought by him at different prices in forty-six purchases over ten years, there had been several stock dividends and reorganizations which complicated the costs, and there were about eighty-eight different sales. Mitchell was an engineer and not an accountant. Nabors had a high school education and business and clerical experience but also was not an accountant. Very large mistakes were made later in an audit by a capable revenue agent; and an accountant employed by Mitchell whose work the Commissioner approved and adopted also went astray, as the Board itself found, and it corrected his results in Mitchell's favor. The particular error or falsity on which alone the Board condemned the 1930 return was that Nabors attributed a large part of the stock sold in 1930 to a block of 5,000 shares, acquired at a relatively high cost, after having in previous years attributed nearly 5,000 shares to that

same stock purchase. Nabors admits that this was done, admits that he knew he could not treat the same stock as sold twice, and is unable to remember how he figured that there was so much of that block left, but he testifies that it was an honest mistake. There is no evidence that Mitchell figured on it or paid any attention to the question at all, though he knew that Nabors was attributing stock sales to the stocks having the highest costs. Mitchell's character and standing are found to be high. Similar errors which appeared in prior returns and subsequent ones might have been some evidence of a dishonest plan, but they have all been pronounced innocent except in this one instance. If, therefore, these similar errors tend to prove anything it would not be fraud but innocent mistake in this instance also.

The Board made elaborate fact findings but did not find the fact directly put in issue by the pleadings — that Mitchell knew the return was false.* The general conclusion that there was fraud with intent to evade tax is explained in an opinion by the majority which seems to us to indicate that they really held that Mitchell and Nabors were grossly careless and for that reason Mitchell ought not to be absolved. To that effect we quote, 40 B.T.A. 447:

> Both petitioner and Nabors, who prepared the 1930 return for petitioner, admitted in their testimony at the hearing that they knew they had no right to use the cost basis of the same block of stock twice; they admitted that by the use of any reasonable degree of diligence they could have ascertained that most of the cost basis of the 5,000-share block had been used up in 1928 and 1929. They gave no reasonable explanation as to why they used the cost basis of the same 5,000-share block of stock twice. . . . We do not think petitioner can be guilty of such careless indifference to the basis of cost of shares of stock which he was selling and to a correct return and the oath to which he subscribed and now expect to be absolved from the consequence of his acts.

The opinion stresses Nabors' inability to explain how he came to use in 1930 the cost basis of stock mostly used up in the returns of former years, despite his testimony that it was unintentional error not deliberately made, and then proceeds: "The substance of petitioner's explanation is that he relied upon the correctness of the computations made by Nabors and that it did not occur to him to question their accuracy. In the light of all the facts in the record, we find ourselves unable to accept this explanation." The Board had found it to be a fact that: "Before signing the returns petitioner would go over the completed returns in a general way with Nabors, but he never checked the clerical computations and details which had been computed by Nabors." We cannot tell whether the Board means to say that Mitchell's negligence in not questioning Nabors' results and not checking his computations was the ground for refusing to accept his explanation, or whether they believed Mitchell knew the return was false and never-

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* The taxpayer reported about $110,000 of income for 1930; the understatement caused by using the erroneous basis was about $210,000. The Board of Tax Appeals, in refusing to accept the taxpayer's explanation, pointed out that there was another overstatement of basis in 1931 (resulting in an understatement of income of about $225,000), although that year was not before it, and that with a cost basis of about $390,000 for the securities in question the taxpayer deducted almost $940,000 in the period 1925-1931. The Board said, 40 B.T.A. 424, 448 (1939): "The Commissioner does not have to establish his determination of fraud 'beyond a reasonable doubt.' All that he is required to do is to make proof of his fraud charges by a preponderance of the evidence which is clear and convincing. In re Locust Building Co., 299 Fed. 756. In the instant case he has proved *clearly* that in filing his income tax return for 1930 petitioner used in large part all over again as his basis of cost for Commonwealth shares sold in that year the cost basis of shares which had been largely used up in the prior years of 1928 and 1929, he has proved that petitioner knew that he had no right to do this, and that the use of such unauthorized basis of cost was largely responsible for an understatement of income for 1930 of $209,040.34. This, in the absence of any satisfactory explanation by petitioner, is convincing proof to us that petitioner's income tax return for 1930 was false and fraudulent with intent to evade tax." — Ed.

theless filed it as true, as the Commissioner had alleged. Negligence, whether slight or great, is not equivalent to the fraud with intent to evade tax named in the statute. The fraud meant is actual, intentional wrongdoing, and the intent required is the specific purpose to evade a tax believed to be owing. Mere negligence does not establish either. Griffiths v. Commissioner, 7 Cir., 50 F.2d 782. We think there ought to be a fact-finding that Mitchell in making this return knew or did not know its probable falsity, and that he intended to evade a tax or did not. If Mitchell, though negligent, acted in good faith and with honest intent, and it is thought that Nabors did not, but that Nabors' bad faith can be visited on Mitchell, the exact facts again ought to be found that the legal application of them may be considered. Another question that has occurred to us, but has not been argued, is how far the Commissioner is bound by the testimony of his own witness Nabors, Nabors not being a party.

We remand the case to the Board for further fact-findings above indicated and for a redetermination, reopening it for additional evidence if either side has any to offer.

Reversed and remanded.

NOTE

1. *The Mitchell case on remand.* On remand, the Board of Tax Appeals made the following disposition of the *Mitchell* case:

> In compliance with the court's order that we should make "further fact-findings as indicated in the opinion of this Court," we have carefully read the opinion of the court and have reexamined the entire record of evidence. After this reexamination, we find ourselves unable to make any material changes in the findings of evidentiary fact upon which our ultimate findings were based, that "Petitioner's income tax return for the year 1930 was false and fraudulent with intent to evade tax and part of the deficiency for that year is due to fraud with intent to evade tax."
>
> As we have already stated, we construe the court's opinion to hold that as a matter of law the evidentiary facts which we have found in our prior report are not sufficient in law to sustain our ultimate finding that there was fraud for the year 1930. . . .
>
> Therefore, in respectful compliance with the opinion of the court and its mandate, we adhere to all of our findings of fact contained in William E. Mitchell, except the last sentence thereof, which was the ultimate finding of fact as to the year 1930 and has been quoted above. We strike out that sentence and the findings of fact which it contains and substitute in lieu thereof the following findings: "In the preparation of petitioner's income tax return for the year 1930, P. H. Nabors who prepared it for him was grossly careless in using as the cost basis of 22,050 shares of Commonwealth stock sold the cost basis of 5,000 shares of Southeastern stock which petitioner had acquired at a high cost in 1927 and substantially all of which had been used in the preparation of petitioner's income tax returns for the years 1928 and 1929 as the basis of cost of stock sold by petitioner in those years. Nabors, by the use of a slight degree of diligence, could have discovered the error and could have avoided it. The petitioner, in signing and swearing to his 1930 income tax return as being correct, was grossly negligent in doing so. He might have, by the exercise of a slight degree of care and diligence, discovered the above mentioned error which led to a large overstatement of the cost of the shares of stock which petitioner sold and a consequent large understatement of his income for 1930. Notwithstanding their gross carelessness in these respects, neither Nabors nor Mitchell had actual knowledge that petitioner's income tax return for 1930 was false."
>
> Therefore on these revised findings of fact and following the opinion of the court in Mitchell v. Commissioner, we conclude that petitioner's income tax return filed for the year 1930 was not false or fraudulent with intent to evade tax and the statute of limitations has barred the deficiency and penalty determined by the Com-

missioner for the year 1930. This results in a holding for petitioner that there is no deficiency for the year 1930 because it is barred by the statute of limitations. Naturally, if there is no deficiency, there can be no penalty. [45 B.T.A. at 825-826.]

2. *Meaning of* "fraud." It is not easy to generalize about what constitutes fraud so as to justify the 50 per cent penalty imposed by §6653(b). Most fraud cases involve systematic or substantial omissions from gross income or wholly fictitious deductions or dependency claims, especially where records are not kept by the taxpayer or are falsified or destroyed. Deficiencies caused by dividends disguised as salary, improper allocations between personal and business expenses, "expensing" items that should be capitalized, depreciation and bad debt deductions, and other items involving the exercise of judgment are seldom the basis for a fraud penalty, unless the intent to evade tax is almost inescapable. Similarily, the fraud penalty is seldom asserted and even less frequently upheld in cases where the deficiency results from a transaction that complies with the letter but not with the spirit of the law. Thus, although in the *Court Holding Co.* case (supra page 675) the Tax Court held that the sale of the property was in substance a sale by the corporation, and that the legal formalities of a liquidation and sale by the stockholders were used "only in the attempt to make the transaction appear to be other than what it was" (2 T.C. 531, 538 (1943)), it refused to find fraud. On the other hand, the *Charles E. Mitchell* case, supra page 952, upheld the fraud penalty where the deficiency resulted from the deduction of loss on a purported sale of securities to the taxpayer's wife (before §267(a) and (b) was enacted), although there was an abundance of paperwork in consummating the transaction. The facts are set out in the opinion of the Board of Tax Appeals, 32 B.T.A. 1093 (1935), and are summarized by the Court of Appeals, 89 F.2d 873 (2d Cir. 1937). In two somewhat comparable cases, the Board of Tax Appeals not only found no fraud but held there was no deficiency. Porter v. Commissioner, 36 B.T.A. 475 (1937); Mellon v. Commissioner, 36 B.T.A. 977, 1048 (1937) (with dissent, id. at 1083).

See Powell v. Granquist, 252 F.2d 56 (9th Cir. 1958) (fraud penalty was properly imposed on a taxpayer who refused to file returns because "he did not believe in the way the government was wasting money"); Muste v. Commissioner, 35 T.C. 913 (1961) (pacifist refused to pay federal income tax because of conscientious objection to war expenditures; held, failure to file returns was not due to "reasonable cause" and 5 per cent penalty applies; but fraud penalty was improperly imposed because taxpayer, who notified government of his refusal to file returns, was not guilty of "bad faith, intentional wrongdoing, sinister motive, or intent to mislead or deceive").

3. *Burden of proof.* In Paddock v. United States, 280 F.2d 563 (2d Cir. 1960), it was held that the government has the burden of proof on the issue of fraud when a taxpayer sues in the District Court for a refund, as well as in deficiency cases in the Tax Court.

The Tax Court holds that a plea of guilty or a conviction in a criminal case is evidence to be weighed in a civil fraud case, but that it is not conclusive. Vassallo v. Commissioner, 23 T.C. 656 (1955); but see Lefkowitz v. Tomlinson, 11 A.F.T.R.2d 617 (S.D. Fla. 1962) (criminal conviction conclusive in later civil fraud case).

If the original tax return has been lost or destroyed by the government and a copy is not available, can a fraud case be based on a net worth computation coupled with a "reconstruction" of the return by working back from the amount of tax actually paid? For discussion of this problem, see Putman v. United States, 301 F.2d 751 (6th Cir. 1962) ("reverse computation," based on assumption that standard deduction was taken and that exemptions were limited to number apparently allowable, not permissible as a means of establishing the contents of the missing return in a fraud case, though it would be appropriate in establishing a deficiency).

4. *References.* Nessen, The Line Between Negligence and Civil Fraud: The Operation of Two Penalty Provisions against Underpaying Taxpayers, 20 N.Y.U. Inst. on Fed. Taxation 1117 (1962); Cutler, Procedures in Civil Fraud Cases, 1960 Tulane Tax Inst. 200.

2. *Criminal Fraud*

Section 7201 of the 1954 Code, relating to a willful attempt to evade or defeat a tax, is identical with §145(b) of the 1939 Code.

Section 7203, relating to a willful failure to pay a tax, file returns, keep records, or supply information, is substantially the same as §145(a) of the 1939 Code.

Section 7206 is based on §§3809(a), 3793(b), 3793(a), 3321(a), and 3762, but the punishment and certain other aspects of earlier law have been changed.

Section 7207, relating to false returns or statements, is based on §3616(a) of the 1939 Code, but with changes.

SPIES v. UNITED STATES
317 U.S. 492 (1943)

MR. JUSTICE JACKSON delivered the opinion of the Court.

Petitioner has been convicted of attempting to defeat and evade income tax, in violation of [§7201]. The Circuit Court of Appeals found the assignment of error directed to the charge to the jury the only one of importance enough to notice. The charge followed the interpretation put upon this section of the statute in O'Brien v. United States, 51 F.2d 193 (C.C.A. 7), and United States v. Miro, 60 F.2d 58 (C.C.A. 2), which followed it. The Circuit Court of Appeals affirmed, stating that "we must continue so to construe the section until the Supreme Court decides otherwise." 128 F.2d 743. One Judge said that as a new matter he would decide otherwise and expressed approval of the dissent in the *O'Brien* case. As the construction of the section raises an important question of federal law not passed on by this Court, we granted certiorari.

Petitioner admitted at the opening of the trial that he had sufficient income during the year in question to place him under a statutory duty to file a return and to pay a tax, and that he failed to do either. The evidence during nearly two weeks of trial was directed principally toward establishing the exact amount of the tax and the manner of receiving and handling income and accounting, which the Government contends shows an intent to evade or defeat the tax. Petitioner's testimony related to his good character, his physical illness at the time the return became due, and lack of willfulness in his defaults, chiefly because of a psychological disturbance, amounting to something more than worry but something less than insanity.

Section [7203] makes, among other things, willful failure to pay a tax or make a return by one having petitioner's income at the time or times required by law a misdemeanor. Section [7201] makes a willful attempt in any manner to evade or defeat any tax such as his a felony. Petitioner was not indicted for either misdemeanor. The indictment contained a single count setting forth the felony charge of willfully attempting to defeat and evade the tax, and recited willful failure to file a return and willful failure to pay the tax as the means to the felonious end.

The petitioner requested an instruction that "You may not find the defendant guilty of a willful attempt to defeat and evade the income tax, if you find only that he had willfully failed to make a return of taxable income and has willfully failed to pay the tax on that income." This was refused, and the Court charged that "If you find that the defendant had a net income for 1936 upon which some income tax was due, and I believe that is conceded, if you find that the defendant willfully failed to file an income tax return for that year, if you find that the de-

fendant willfully failed to pay the tax due on his income for that year, you may, if you find that the facts and circumstances warrant it find that the defendant willfully attempted to evade or defeat the tax." The court refused a request to instruct that an affirmative act was necessary to constitute a willful attempt, and charged that "Attempt means to try to do or accomplish. In order to find an attempt it is not necessary to find affirmative steps to accomplish the prohibited purpose. An attempt may be found on the basis of inactivity or on refraining to act, as well."

It is the Government's contention that a willful failure to file a return, together with a willful failure to pay the tax, may, without more, constitute an attempt to defeat or evade a tax within [§7201]. Petitioner claims that such proof establishes only two misdemeanors under [§7203], and that it takes more than the sum of two such misdemeanors to make the felony under [§7201]. The legislative history of the section contains nothing helpful on the question here at issue, and we must find the answer from the section itself and its context in the revenue laws.

The United States has relied for the collection of its income tax largely upon the taxpayer's own disclosures rather than upon a system of withholding the tax from him by those from whom income may be received. This system can function successfully only if those within and near taxable income keep and render true accounts. In many ways, taxpayers' neglect or deceit may prejudice the orderly and punctual administration of the system as well as the revenues themselves. Congress has imposed a variety of sanctions for the protection of the system and the revenues. The relation of the offense of which this petitioner has been convicted to other and lesser revenue offenses appears more clearly from its position in this structure of sanctions.

The penalties imposed by Congress to enforce the tax laws embrace both civil and criminal sanctions. The former consist of additions to the tax upon determinations of fact made by an administrative agency and with no burden on the Government to prove its case beyond a reasonable doubt. The latter consist of penal offenses enforced by the criminal process in the familiar manner. Invocation of one does not exclude resort to the other. Helvering v. Mitchell, 303 U.S. 391.

The failure in a duty to make a timely return, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, is punishable by an addition to the tax of 5 to 25 per cent thereof, depending on the duration of the default. [§6651(a).] But a duty may exist even when there is no tax liability to serve as a base for application of a percentage delinquency penalty; the default may relate to matters not identifiable with tax for a particular period; and the offense may be more grievious than a case for civil penalty. Hence the willful failure to make a return, keep records, or supply information when required, is made a misdemeanor, without regard to existence of a tax liability. [§7203.] Punctuality is important to the fiscal system, and these are sanctions to assure punctual as well as faithful performance of these duties.

Sanctions to insure payment of the tax are even more varied to meet the variety of causes of default. It is the right as well as the interest of the taxpayer to limit his admission of liability to the amount he actually owes. But the law is complicated, accounting treatment of various items raises problems of great complexity, and innocent errors are numerous, as appears from the number who make overpayments. It is not the purpose of the law to penalize frank difference of opinion or innocent errors made despite the exercise of reasonable care. Such errors are corrected by the assessment of the deficiency of tax and its collection with interest for the delay. [§§6601(a) and 6654(a).] If any part of the deficiency is due to

negligence or intentional disregard of rules and regulations, but without intent to defraud, five per cent of such deficiency is added thereto; and if any part of any deficiency is due to fraud with intent to evade tax, the addition is 50 per cent thereof. [§6653(a) and (b).] Willful failure to pay the tax when due is punishable as a misdemeanor. [§7203.] The climax of this variety of sanctions is the serious and inclusive felony defined to consist of willful attempt in any manner to evade or defeat the tax. [§7201.] The question here is whether there is a distinction between the acts necessary to make out the felony and those which may make out the misdemeanor.

A felony may, and frequently does, include lesser offenses in combination either with each other or with other elements. We think it clear that this felony may include one or several of the other offenses against the revenue laws. But it would be unusual and we would not readily assume that Congress by the felony defined in [§7201] meant no more than the same derelictions it had just defined in [§7203] as a misdemeanor. Such an interpretation becomes even more difficult to accept when we consider this felony as the capstone of a system of sanctions which singly or in combination were calculated to induce prompt and forthright fulfillment of every duty under the income tax law and to provide a penalty suitable to every degree of delinquency.

The difference between willful failure to pay a tax when due, which is made a misdemeanor, and willful attempt to defeat and evade one, which is made a felony, is not easy to detect or define. Both must be willful, and willful, as we have said, is a word of many meanings, its construction often being influenced by its context. United States v. Murdock, 290 U.S. 389. It may well mean something more as applied to nonpayment of a tax than when applied to failure to make a return. Mere voluntary and purposeful, as distinguished from accidental, omission to make a timely return might meet the test of willfulness. But in view of our traditional aversion to imprisonment for debt, we would not without the clearest manifestation of Congressional intent assume that mere knowing and intentional default in payment of a tax, where there had been no willful failure to disclose the liability, is intended to constitute a criminal offense of any degree. We would expect willfulness in such a case to include some element of evil motive and want of justification in view of all the financial circumstances of the taxpayer.

Had [§7203] not included willful failure to pay a tax, it would have defined as misdemeanors generally a failure to observe statutory duties to make timely returns, keep records, or supply information — duties imposed to facilitate administration of the Act even if, because of insufficient net income, there were no duty to pay a tax. It would then be a permissible and perhaps an appropriate construction of [§7201] that it made felonies of the same willful omissions when there was the added element of duty to pay a tax. The definition of such nonpayment as a misdemeanor, we think, argues strongly against such an interpretation.

The difference between the two offenses, it seems to us, is found in the affirmative action implied from the term "attempt," as used in the felony subsection. It is not necessary to involve this subject with the complexities of the common-law "attempt." The attempt made criminal by this statute does not consist of conduct that would culminate in a more serious crime but for some impossibility of completion or interruption or frustration. This is an independent crime, complete in its most serious form when the attempt is complete, and nothing is added to its criminality by success or consummation, as would be the case, say, of attempted murder. Although the attempt succeed in evading tax, there is no criminal offense of that kind, and the prosecution can be only for the attempt. We

think that in employing the terminology of attempt to embrace the gravest of offenses against the revenues, Congress intended some willful commission in addition to the willful omissions that make up the list of misdemeanors. Willful but passive neglect of the statutory duty may constitute the lesser offense, but to combine with it a willful and positive attempt to evade tax in any manner or to defeat it by any means lifts the offense to the degree of felony.

Congress did not define or limit the methods by which a willful attempt to defeat and evade might be accomplished and perhaps did not define lest its effort to do so result in some unexpected limitation. Nor would we by definition constrict the scope of the Congressional provision that it may be accomplished "in any manner." By way of illustration, and not by way of limitation, we would think affirmative willful attempt may be inferred from conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind, and any conduct, the likely effect of which would be to mislead or to conceal. If the tax-evasion motive plays any part in such conduct the offense may be made out even though the conduct may also serve other purposes such as concealment of other crime.

In this case there are several items of evidence apart from the default in filing the return and paying the tax which the Government claims will support an inference of willful attempt to evade or defeat the tax. These go to establish that petitioner insisted that certain income be paid to him in cash, transferred it to his own bank by armored car, deposited it, not in his own name but in the names of others of his family, and kept inadequate and misleading records. Petitioner claims other motives animated him in these matters. We intimate no opinion. Such inferences are for the jury. If on proper submission the jury found these acts, taken together with willful failure to file a return and willful failure to pay the tax, to constitute a willful attempt to evade or defeat the tax, we would consider conviction of a felony sustainable. But we think a defendant is entitled to a charge which will point out the necessity for such an inference of willful attempt to defeat or evade the tax from some proof in the case other than that necessary to make out the misdemeanors; and if the evidence fails to afford such an inference, the defendant should be acquitted.

The Government argues against this construction, contending that the milder punishment of a misdemeanor and the benefits of a short statute of limitation* should not be extended to violators of the income tax laws such as political grafters, gamblers, racketeers, and gangsters. We doubt that this construction will handicap prosecution for felony of such flagrant violators. Few of them, we think, in their efforts to escape tax, stop with mere omission of the duties put upon them by the statute, but if such there be, they are entitled to be convicted only of the offense which they have committed.

Reversed.

NOTE

1. *Implications of Spies case.* In the case of a taxpayer who files no tax return, can the required "affirmative willful attempt" to evade be found in his intentional failure to keep adequate business records? If the taxpayer files a return and a net worth computation or other indirect reconstruction indicates that his income was substantially

* The period of limitations under §3748 of the 1939 Code was six years for prosecutions for willful evasion of tax but only three years for willful failure to file a return or to pay a tax; §6531 of the 1954 Code, however, provides a six-year period for both criminal offenses. — Ed.

greater than the amount reported by him, is the disparity sufficient to warrant a criminal prosecution, or must some "badge of fraud" be established?

Relying on *Spies*, a court has upset a conviction under §7201 of a person engaged in the business of preparing tax returns for other persons, his misconduct consisting of preparing returns but failing to file them in order to keep the taxpayer's payments. United States v. Mesheski, 286 F.2d 345 (7th Cir. 1961).

2. *The Spies case and civil fraud.* First Trust & Savings Bank v. United States, 206 F.2d 97 (8th Cir. 1953), involved a taxpayer who pleaded guilty and was fined on a charge of willfully failing to file a return under §7203. A 50 per cent civil fraud penalty was assessed, but the Court of Appeals held that a willful failure to file a return was not sufficient to permit an assessment under §6653(b), although it would justify the 25 per cent addition of §6651(a). Relying on the *Spies* case, the court, one judge dissenting, said:

> The distinction between the lesser and the graver derelictions which govern the larger and the smaller civil additions to tax is of exactly the same character as that found by the Supreme Court [in the *Spies* case] in respect to the criminal penalties. Manifestly willful failure to file returns may have the same effect on the collection of the revenue as an attempt to evade a tax. But Congress makes the difference on the civil side as it does on the criminal side, between the taxpayer whose deficiencies of tax are due to (or caused by) his affirmative commission of fraud and the one whose deficiencies are due to willful omission to make return. That omission justifies the addition of 5 per cent up to 25 per cent of the deficiencies found against the taxpayer but does not afford any basis for the addition of 50 per cent to his deficiencies. Only the commission of acts of fraud with intent to evade tax to which "the deficiencies are due" (or which bring about the deficiencies) affords a basis for the 50 per cent addition to tax. [206 F.2d at 100-101.]

The House version of the 1954 Code made a felony of willful failure to file a tax return, but the Senate refused to agree, and the Code as enacted preserves the distinction of the *Spies* case and the 1939 Code.

UNITED STATES v. DURANT

324 F.2d 859 (7th Cir. 1963)

Before HASTINGS, Chief Judge, and SCHNACKENBERG and CASTLE, Circuit Judges.

SCHNACKENBERG, Circuit Judge.

Lyndon A. Durant, defendant, having been indicted under §7201 and charged in three counts with willfully attempting to defeat and evade a part of income tax due and owing by him and his wife to the United States of America, for the calendar years 1954, 1955, 1956, the deficiency totaling $142,714.40, pleaded not guilty and was tried by the court without a jury.

The court having denied defendant's motions for judgment of acquittal at the close of the government's case and at the close of all the evidence, defendant was found guilty on each count and judgment was entered accordingly. Defendant was sentenced to the custody of the attorney general for a period of 60 days on each count, the sentences to run concurrently, and fined $15,000 and costs. From said judgment defendant appealed to this court.

According to the stipulated proof, unreported income totalling $212,328.97 upon which the tax deficiency for the three years is computed, was derived from corporate expenditures of United Manufacturing Company, an Illinois corporation, Chicago, Illinois, made for the personal benefit of taxpayer. The immediate beneficiaries of these expenditures, other than defendant personally, are identified in the stipulations. These expenditures numbered 2572 and involved the issuance of 686 corporate checks. They were charged chiefly to corporate expense accounts for travel, automobile, entertainment and selling, and also to

freight, office expense, engineering, contributions, professional services, factory expense, office equipment, dues and subscriptions, rent and advertising. . . .

None of these items was charged to the personal account of taxpayer, which was carried on the corporate books under the title "L. A. Durant." It appears that this account had been maintained since the incorporation of United and even prior thereto during the period 1943 to 1946, when the business was operated as a sole proprietorship. During the entire prosecution period 1954-1956, this account was charged only three times for a total of $2,700.26 with purchases from the vendors who supplied the 2572 stipulated items involving the amount of the income not reported by defendant upon which this case rests. The government points out that, while there is evidence that defendant from time to time had given instructions on charging items to this account, there is no evidence cited to us that he ever gave explicit instructions to any corporate employee how to charge any of the 2572 items in issue. We have found none.

The government's position is that defendant knew that these items would not be charged to his account in the absence of instructions from him, that he intended they should be charged to corporate expense accounts, that he knew they constituted income to him and that he willfully suppressed this additional income to him in his joint income tax returns. The trial court so found, and the government submits its findings are amply supported by the evidence.

On the other hand, defendant insists that he had assumed that all items paid by the corporation for his personal benefit were being charged to his personal account. Although he testified that he could not recall telling anyone specifically to make a charge to his personal account, he testified that, if he made any withdrawals from the corporation, it was his understanding that he would have to repay them.

H. L. Oettinger, an experienced accountant, in 1946 was hired by defendant as overseer of the office. He had the responsibility of seeing that the distribution of expenses was proper. To him defendant delegated the administrative end of the business. In July of 1951 Walter B. Taibleson, a certified public accountant, became comptroller of United. He prepared tax returns for the years 1951 through 1955.

According to Frances Croson, the accounts payable clerk, two routines were used for handling bills. Generally they were received, analyzed and classified for distribution to the proper account and paid by check on a weekly basis, with the assistance of a National Cash Register office machine. The alternative routine was to expedite particular items on an individualized basis, in which case the checks were typed out as needed, and distributed once a month to various corporate accounts. These so-called "typed checks" had a detachable bottom portion for purposes of recording the expenditure as to payee, nature of purchase, classification, etc. Carl Olson, purchasing agent, received the bulk of the purchase bills for purpose of noting the proper account distribution. Other bills went to the specific persons to whom addressed or who were responsible for a particular account.

On classification questions, according to Miss Croson, in 1950 more bills without any indication as to distribution began coming through to her; that, prior to that the number of bills without any indication as to distribution was negligible; that some of the bills came to her and some to Oettinger, who would hand them to her; that, in the beginning, she would ask Oettinger how such bills would be distributed, and he invariably replied, "Use your best judgment"; that she never discussed procedures with defendant. During 1948, the bills generally came to her already bearing a notation of the proper account distribution. When items such as Marshall Field, Saks Fifth Avenue and Bonwit Teller, became

larger and more numerous, she asked Oettinger, who told her to "handle them as best you can" and she distributed them as similar items had been handled before. Defendant, and Oettinger also, would ask her to make out "typed checks" to various persons, but neither ever told her how to charge them.

Occasionally it was defendant's practice to give bills to Taibleson or to Oettinger for payment, but not to indicate how such bills should be charged. However, defendant did at times give instructions to charge himself personally or to a corporate project called "Caravan," based at Denver, which was engaged in development of electronic devices in connection with drilling of wells. In the absence of any such indication, the practice was to charge an expenditure to a corporate expense account.

As to many of the indictment items, defendant instructed his employees personally either to issue a check and return it to him; to issue a check in payment of a bill, where the only documentation of such bill was defendant's oral direction; to draw petty cash and give the funds to him; or to purchase merchandise for him to be disposed of at his personal direction or shipped where he designated. Defendant never did explain to employees that such items all of which were herein stipulated as personal, were not business expenses but were personal to him.

Defendant also took blank checks with him on trips out of the city and, according to custom, needed no one's authority to do this. On occasion, he returned the bottom half of the check to the bookkeeping department. Of those items in evidence of such a nature, in only two instances did he indicate the purpose on the voucher portion as shown in the following two paragraphs. In all other instances he made no indication of the purpose for which the check was written. If Durant did not furnish this bottom half, or voucher portion, not only was there no way of knowing the purpose for which it was drawn, but the company was unaware it was issued until it cleared the bank. . . .

In 1951, agent Zivin examined United's and defendant's returns for 1949 and 1950. He made no third-party investigation of certain unsubstantiated expenses disallowed to the corporation, and also could not readily determine from the corporate books which were items of expenditure made for the benefit of defendant. He reviewed these items several times with Oettinger and Durant to determine their true nature. In December 1951, in a final conference Zivin so stated to Oettinger and defendant, with a warning that this practice had to be stopped, to which defendant replied, that if it had been done it was a mistake and that the items should have been charged to his personal account.

Zivin's itemized report of the corporation's personal and unsubstantiated expenses which he charged to defendant showed the following totals:

L. A. Durant

	Personal	No Substantiation
1949	$ 3,055.50	$47,400.00
1950	39,534.71	74,342.86

Zivin charged both categories to defendant as dividends. Sworn protests were filed in which defendant alleged that, with the exception of nine items, all disallowed expenses were exclusively devoted to official corporate expense by defendant.

The case was reassigned to revenue agent Wagar, who consulted Zivin's reports and examined the years 1951, 1952 and 1953. Without any third-party investigation, Wagar prepared reports dated April 26, 1954, proposing certain adjustments covering the years 1949 through 1953, and disallowing to the corporation

certain of the expenses claimed and charging to defendant as dividends certain amounts for each year. Before submitting his report, Wagar discussed with defendant the practice of taking corporate tax deductions for personal expenditures and said this practice was improper. Defendant did not explain how they came to be charged to corporate expense accounts. Wagar's report contained an itemized listing of corporate expense items determined to be personal in nature. Defendant discussed with the comptroller, Taibleson, the selling and travel expenses disallowed by Wagar.

The proposed assessments were settled by agreements for payments of additional corporate and personal taxes, totaling about $600,000.

Thereafter, defendant's personal expenditures continued to be paid by and charged to the corporation. During 1954, 1955 and 1956, $79,104.95 in personal items was actually disbursed to vendors who had been identified with dividend items charged to defendant in the prior audits. Defendant admitted that he made no changes in the accounts payable routine.

Defendant himself testified that in 1951 or 1952 he met with Agent Zivin and that, on some unfixed date in 1954, he had a conversation with Agent Wagar. He admitted that there was a discussion with Zivin about personal items that the corporation had paid for. He "assumed" that he knew what the discussion with Zivin "was all about."

He testified that he read and signed a protest against Zivin's ruling, prepared by his lawyers.

We first dispose of the contention of defendant that, if he had an intent to repay United Manufacturing Company for personal expenses paid by it on his behalf, the fact that they were not charged to his personal account has no effect, but they are loans. He cites Estate of Helene Simmons, 26 T.C. 409 (1956), Carl L. White, 17 T.C. 1562 (1952), and Walter Freeman, 16 T.C.M. 71 (1957).

In the case at bar, the district court found that the record is clear that at no time were the payments in question ever considered as loans by the parties. The corporation did not carry them on its books as notes or accounts receivable; no notes or other evidence of loans were ever executed by the defendant; no interest was ever paid to the corporation by the defendant; no maturity or repayment date was set; no repayment was made; defendant never advised any of the responsible subordinates that the payments were to be treated as loans and charged to his personal account; in fact, no action was taken by either the defendant or the corporation which would indicate that the payments were loans.

The district court found that the payments made by the corporation in the taxable years for defendant's benefit were income to defendant, which was known to defendant. This finding is supported by the uncontradicted evidence in the record, most of it stipulated.

Accordingly we hold that the payments by the corporation for the benefit of defendant were not loans by it to defendant, but were income. . . .

Defendant submits that the most that can be inferred from the evidence in this case is a certain amount of laxity, but his counsel urges that any amount of laxity does not constitute the requisite willfulness.

As an abstract proposition, we would agree that no amount of laxity in and of itself constitutes willfulness. However, in the case at bar, we believe that the district court properly recognized the additional factors revealed by the records, tending to prove a willful intent: (a) defendant knew the corporation was paying his expenses, (b) the payments were not considered loans by the parties, (c) defendant knew the corporate payments were income to him; and therefore properly found that defendant willfully failed to include them in his returns.

As we have indicated, the events following the prior audits for 1949-1953 served

to clearly warn defendant of his duty to report as his personal income the charges of indebtedness incurred by him and paid by the corporation. Moreover, his failure to indicate on many of the expenditure vouchers any notation indicating appropriate classifications leading to a proper charge to him personally, also tends to support the finding of willfulness.

His continuous failure to see that the warnings of Zivin and Wagar were heeded might reasonably be expected to result in a continuation of the practice of charging his personal obligations to the corporation.

We are not concerned here with any ethical question as to the propriety of defendant's benefactions to various ladies. No requirement of federal tax laws bars such nurture of cordial relations with them. Yet the court, as the trier of the facts, had a right to consider the repeated charges to the corporation for gifts by defendant to feminine acquaintances despite the previous warnings, and to find that he had deliberately and willfully continued to permit the making of such improper charges. By the sequence of events, the continuation of that practice, which in prior years may have resulted from defendant's negligence, in the years 1954, 1955 and 1956 became deliberate and willful.

Whether defendant willfully attempted to defeat and evade taxes in this case presented a question for the trier of the facts. There was substantial evidence before the court to support the result which it reached. The credibility of defendant as a witness and the weight to be given to his testimony were peculiarly within the knowledge of the court, which had an opportunity to observe his demeanor while testifying. On appeal, we are forced to hold, as we do, that there was sufficient evidence viewed in the light most favorable to sustain the court's finding, to prove the charge upon which defendant was tried. Blauner v. United States, 8 Cir., 293 F.2d 723, 725 (1961); United States v. Dudley, 2 Cir., 260 F.2d 439, 440 (1958); United States v. Tutino, 2 Cir., 269 F.2d 488, 490 (1959). Cf. Wolfe v. United States, 6 Cir., 261 F.2d 158, 160 (1958).

For these reasons, the judgment from which defendant has appealed is affirmed.

Judgment affirmed.

NOTE

1. *Fraudulent corporate return.* Could the defendant have been convicted on the same evidence of violating the same statutory provision (§7201) by causing the corporation to file a fraudulent return? See §7343 (term "person" as used in §7201 includes an officer or employee of a corporation who "is under a duty to perform the act in respect of which the violation occurs"); Blauner v. United States, cited in the *Durant* case (conviction of corporate officer under §7201 upheld because he was "responsible" for corporate tax return although he did not sign it); United States v. Haskell, 327 F.2d 281 (2d Cir. 1964) (conspiracy between corporate officer and key employee to evade corporate and personal income taxes).

2. *Willful failure to pay tax.* If the taxpayer files a proper return, but fails to pay the tax because he prefers to spend his money on wine, women, and song — or to use it in a foundering business venture — is he guilty of a violation of §7203 (willful failure to pay taxes at the time required by law)? In United States v. Palermo, 259 F.2d 872 (3d Cir. 1958), the court applied the *Spies* requirement of "a specific wrongful intent — an evil motive" as distinguished from "mere laxity, careless disregard of the duty imposed by law, or even gross negligence" in reversing a conviction based, inter alia, on these facts:

> At a time when he [the taxpayer] owed some $6,000 for income tax for the years 1948 and 1949 he bought a $25,000 property in Ventnor City, New Jersey, making a $10,800 cash payment thereon at the settlement, April 28, 1950. On May 19, 1954, when he owed a large amount of income tax going back to 1949, including all the

1953 tax, he purchased a new $5,020.21 automobile, a Cadillac DeVille, paying $1,520.21 in cash and financing the balance. On February 16, 1955, he purchased a new $5,547.63 Cadillac Eldorado for which he paid $1,549.50 in cash and traded in another car for the balance. At this time he owed a large amount of income tax for years going back to 1949, including all the 1953 tax, and his 1954 tax was almost due. On or about January 6, 1956, defendant paid $6,080 for a sumptuous wedding banquet for his daughter, even though at the time he owed income tax amounting to some $14,000 for the years 1949 to 1954, inclusive, with the 1955 tax still to be paid. There were 472 guests at the banquet. Included in the cost of the banquet were $2,030 for liquor and $1,000 for Duke Ellington's orchestra. [157 F. Supp., 580 (E.D. Pa. 1957).]

The government seldom prosecutes the taxpayer who files a proper and timely return for failure to pay, possibly because this area is haunted by the specter of imprisonment for debt.

If the taxpayer not only fails to pay his taxes, but impedes the government's collection procedures by concealing assets, etc., the requirement in the *Spies* and *Palermo* cases of "an evil motive" is more easily satisfied. Indeed, in the face of such tactics, the government may not be content with charging the taxpayer with a misdemeanor under §7203, and may instead charge him with committing a felony under §7201, which speaks of a willful attempt "to evade or defeat any tax . . . or the payment thereof." In Cohen v. United States, 297 F.2d 760 (9th Cir. 1962), a taxpayer who had been convicted under §7201 of filing false returns for 1946-1948 was convicted under the same statute of willfully attempting to evade payment of taxes for the same years (by concealing assets, using dummies to effect his transactions, etc.). The court held that the second prosecution, which was based on events occurring after the first conviction, did not put the taxpayer in double jeopardy.

3. *Other criminal offenses applicable to tax delinquencies.* Section 7201 (willful attempt to evade) and §7203 (willful failure to file return, supply information, or pay tax) are only two of the weapons in the government's arsenal. In addition to the other offenses set out in the Internal Revenue Code (§§7201-7215), there are also provisions of the Criminal Code that must be taken into account, including §1001 (false statements), §371 (conspiracy), and §1621 (perjury). The language of these provisions overlaps in a confusing fashion, giving rise to many troublesome questions, including the extent to which the field is pre-empted by a particular provision, the statute of limitations to be applied, and the right of a defendant who is charged under one provision to be convicted of a "lesser included offense." See United States v. Beacon Brass Co., 344 U.S. 43 (1952) (statute of limitations where taxpayer was charged under §7201 and had made a false statement during the investigation that constituted a violation of §1001, Criminal Code); Achilli v. United States, 353 U.S. 373 (1957) (prosecution under §7201; held, not barred by existence of §7207); United States v. Rayor, 204 F. Supp. 486 (S.D. Cal. 1962) (false statement is punishable under §7206(1) even if not material, although materiality is essential under Criminal Code §1001); United States v. McCue, 301 F.2d 452 (2d Cir. 1962) (§1001 of Criminal Code applicable to false oral statements made by taxpayer in course of investigation); Berra v. United States, 351 U.S. 131 (1956) (prosecution under §7201; held, no need to instruct jury re §7207); Janko v. United States, 281 F.2d 156 (8th Cir. 1960) (extensive discussion of "lesser included offense" issue) (reversed on other grounds, 336 U.S. 716); Grunewald v. United States, 353 U.S. 396 (1957) (conspiracy).

4. *Investigation and trial of tax fraud cases.* In addition to the materials cited supra page 897 on the subject of tax investigations, see Campbell v. Eastland, 307 F.2d 479 (5th Cir. 1962) (application for discovery by taxpayer-plaintiff in refund action while he was a potential defendant in fraud prosecution); United States v. Fancher, 195 F. Supp. 448 (D. Conn. 1961) (discovery in fraud prosecution); Palermo v. United States, 360 U.S. 343 (1959) (application of "Jencks Act" to revenue agents' reports); Burke v. United States, 279 F.2d 824 (8th Cir. 1960) (same).

5. *Illegal income and the Fifth Amendment.* On the relation of the privilege against self-incrimination to the reporting of illegal income, see page 117 supra.

6. *Voluntary disclosure of tax fraud.* Until 1952, the Treasury Department followed a policy of not recommending prosecution of taxpayers who made a "voluntary dis-

closure" of tax fraud. At one time, an admission was "voluntary" in the eyes of the Treasury if the taxpayer acted before he knew he was under investigation; later, he had to act before an investigation was in fact under way. Although the promise of immunity was not judicially enforceable, United States v. Lustig, 163 F.2d 85 (2d Cir. 1947), cert. denied, 332 U.S. 775, it was in fact observed in practice; and it was widely believed that evidence could be suppressed on the taxpayer's motion if furnished in circumstances constituting a voluntary disclosure as defined by the Treasury's announced policy. There were a number of cases in which the taxpayer claimed, and the agent denied, the making of an oral disclosure, however, and always present was the possibility of collusion by an agent in pre-dating a memorandum setting out a voluntary disclosure. See Shotwell Mfg. Co. v. United States, 371 U.S. 341 (1963), holding that a dishonest disclosure did not meet the administrative requirements and that evidence so furnished could be properly used by the government; the dissent, at 368n, cites the relevant announcements.

In 1952, the voluntary disclosure policy was abandoned by the Treasury Department, with the following announcement:

> While it has been the long-established policy of the Treasury Department to refrain from recommending criminal prosecution where taxpayers make voluntary disclosure of intentional tax evasion prior to the initiation of an investigation by the Bureau of Internal Revenue, it has been concluded that such policy will no longer be followed. Litigation in the courts in recent years has illustrated the controversial nature of the question as to what constitutes a true voluntary disclosure in fact. In the administration of the policy it has been difficult and at times impossible to ascertain whether the disclosure was made because the taxpayer realized he was under investigation or whether the disclosure was in fact voluntary and in reliance on the immunity held out by the policy.
>
> The intensified enforcement activities of the Bureau's special tax fraud drive and racket squads throughout the country are ferreting out the willful tax evaders, and resulting in recovery of the additional taxes and penalties due the Government. It is the policy of the Treasury Department to recommend criminal prosecution in every case where the facts and circumstances warrant that action.

The A.B.A.'s Section of Taxation has recommended several times that a formal voluntary disclosure policy be reinstituted. See A.B.A., Section of Taxation, Bulletin, Oct. 1961, p. 32. See also Advisory Group on Administration of Internal Revenue Service, Report to House Ways and Means Committee (subcommittee on Internal Revenue Taxation) (1957) 70-71; Hearings, Subcommittee of House Ways and Means Committee, 82d Cong., 2d Sess., Jan. 22-25, 1952, passim.

In the absence of a formal "no prosecution" policy, the Internal Revenue Service and the Department of Justice presumably take a voluntary disclosure into consideration along with all other circumstances in deciding whether to prosecute, since a confession before investigation may weigh favorably with a jury. Pointing out in 1962 that the advent of electronic data processing may flush out some previously unknown tax evaders, the Commissioner of Internal Revenue advised delinquent taxpayers to put their houses in order by filing returns currently, and added that "the Service will carefully consider and weigh [a voluntary disclosure of past delinquency], along with all other facts and circumstances in deciding whether to recommend prosecution." Note, 16 J. Taxation 104 (1962).

7. *Is tax fraud immoral?* Is it "immoral" or an indication of "moral turpitude" to evade federal income taxes? See Jordan v. De George, 341 U.S. 223 (evasion of liquor taxes involves moral turpitude, warranting deportation of alien); Kahn v. Barber, 253 F.2d 547 (9th Cir. 1958) (accord, as to income tax evasion); In re Nunan, 211 N.Y.S.2d 633 (attorney sentenced to 5 years' imprisonment for federal tax evasion; held, action constitutes "professional misconduct" warranting, in view of otherwise good record, one year's suspension from practice); Furnish v. Board of Medical Examiners, 308 Pac. 2d 924 (Calif. 1957) (physician; suspended one year). See also Cahn, The Moral Decision (1955) 164ff; Wilson, The Cold War and the Income Tax: A Protest (1963).

8. *References.* Balter, A Ten Year Review of Fraud Prosecutions, 19 N.Y.U. Inst. on Fed. Taxation 1125 (1961); Rothwacks, Law and Procedure in Criminal Tax Prosecu-

tions, 26 Taxes 797 (1948); Lipton and Petrie, The Substantial Understatement Requirement in Criminal Tax Fraud Cases, 19 N.Y.U. Inst. on Fed. Taxation 1175 (1961); Wallace, Penalties and Prosecutions for Evasion of the Federal Income Tax, 1 Tax L. Rev. 329 (1946); Lyon, The Crime of Income Tax Fraud: Its Present Status and Function, 53 Colum. L. Rev. 476 (1953); A.B.A., Section on Taxation, Symposium on Procedure in Tax Fraud Cases (1951); Murphy, Criminal Income Tax Evasion, 48 Nw. U.L. Rev. 317 (1953); Winer, An Appraisal of Criminal and Civil Penalties in Federal Tax Evasion Cases, 33 B.U.L. Rev. 387 (1953); Note, Constitutional Aspects of Federal Tax Investigations, 57 Colum. L. Rev. 676 (1957); Note, the Inquisitorial Powers of the Federal Government in Third Party Tax Investigations, 41 Minn. L. Rev. 800 (1957); Schmidt and Thatcher, Lesser Included Income Tax Offenses, 16 Tax L. Rev. 463 (1961); Fahey, Testimonial Privilege of Accountants in Federal Tax Fraud Investigations, 17 id. 491 (1962), Jones, Voluntary Disclosure Policy of the Treasury Department, 6 Tax L. Rev. 329 (1951).

See also page 117 supra for references on the "required records" doctrine.

SECTION F. THE LAWYER'S ROLE

RANDOLPH PAUL, THE LAWYER AS A TAX ADVISER

*25 Rocky Mountain Law Review 412 (1953)**

Analysis of the ethical problems of lawyers as tax advisers has many of the fascinating and challenging qualities associated with exploration of a moral and legal frontier. One gets quickly to the borderlands of knowledge of the subject. I would guess that a fairly general ignorance upon the subject is partly in the realm of philosophy and partly a matter of application. Until recently very few tax lawyers have given much thought to the ethics that should govern the practice of their profession. Moreover, tax law as a specialized field of practice is still in its comparative infancy. There is no venerable tradition to compel the adherence of the tax bar to fixed rules of behavior, and there are very few illustrious examples in a short past to guide the lawyer's conduct. There has hardly been time to evolve a new creed to fit a rapidly developing group of ethical problems. Technical problems of the most baffling character have monopolized the capacities of tax practitioners who have used all their energies in trying to keep pace with the multiplying intellectual complexities of a vast modern product of the law. Tax counselors have therefore lacked opportunity to develop a solid core of philosophy to serve as chart and compass when they encounter the ethical problems constantly arising to plague them in the daily round of their exacting work.

The ethical problems arising in the life of tax practitioners are not simple, copybook problems. It is not possible, in ex-President Hoover's analogy, to make the rules controlling their conduct in practice "as clear as the Ten Commandments." Most tax practitioners will not countenance fraudulent conduct in any crude sense of that term. To a suggestion that a taxpayer may evade taxes by omissions or false understatements of income in his return, by deceptive overstatements of items of deduction, by fictitious entries in books of account, or by concealing assets from the revenue collector, most tax advisers will quickly make the blunt reply that they will not participate in a transaction involving such elementary misconduct. This type of situation rarely presents a serious problem for tax counsel. He knows that he should not have even an advisory part in any transaction involving methods of tax evasion which plainly cross the line of legality. His moral instincts and training forbid participation; in addition, he

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knows very well that participation will sooner or later end in disaster for his professional career. Tax evasion in this brutal sense of the term "evasion" is a risky game that cannot be won. As Chief Justice Vinson once tersely remarked when he was Secretary of the Treasury: "There is no future in it."

As a matter of fact, the morals of most clients are far above the level which would sanction unmitigated fraud of this variety, even if they were convinced that it would go undetected. Moreover, they are unwilling to take the risks involved in plainly fraudulent conduct, nor do they often present to their tax advisers proposals involving wilful attempts to evade or defeat tax liability. The ethical problems presented to tax advisers are of a more subtle character. Borderline questions are presented which usually have enough potential argument in their favor to furnish some basis for rationalization leading to a decision to act in the apparent immediate financial interest of the taxpayer.

Advising As To Potential Tax

Analysis of the ethical responsibilities of tax advisers may profitably start at the earliest point in the adviser's contact with transactions involving potential tax liability. . . .

A taxpayer may desire to reduce the tax liability implicit in an existing distribution of wealth among the members of his family or to avoid unnecessary income or gift tax in connection with a divorce settlement. No prudent businessman enters into an important business transaction without consultation with his tax attorney before he crosses the Rubicon. The businessman may wish to avoid some hidden pitfall, or more affirmatively he may wish to reduce to the lowest legal minimum the taxes which may result from a business transaction into which he is about to enter. . . .

If a tax attorney is to handle this type of work capably, and the later work of representing clients before the Treasury and the courts in connection with transactions involving attempts to minimize tax, he must first organize his philosophy on the subject of tax avoidance. A coherent philosophy is vital to a consistent and effective attitude. Some tax attorneys have a vaguely uncomfortable feeling, which does not always reach the point of consciousness, that there is something "mildly unethical" in the desire of taxpayers to minimize tax liability, and that it is at least a venial sin to give consideration to the tax consequences of future transactions. This is not so. The standards of tax law are external standards, except in those instances in which the statute itself indicates that "purpose or state of mind determines the incidence" of the tax. "Moral predilections must not be allowed to influence our minds in settling legal distinctions." [1] There is no moral turpitude and nothing sinister in arranging one's affairs so as to keep taxes as low as possible. As Judge Learned Hand has emphatically said: "Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." . . .[2]

Justise Holmes expressed a personal attitude toward taxes when he said: "I like to pay taxes. With them I buy civilization." [3] His judicial attitude toward

1 Holmes, The Common Law 148 (1881).

2 Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947), cert. denied, 331 U.S. 859 (1947). Judge Learned Hand dissented in this case, but the disagreement related to other matters involving the construction of a trust instrument. . . .

3 Frankfurter, Mr. Justice Holmes and the Supreme Court 42 (1938). See also Holmes dissenting in Compania General De Tabacos De Filipinas v. Collector, 275 U.S. 87, 100 (1927); New York ex rel. Cohn v. Graves, 300 U.S. 308, 313 (1937); Frankfurter, dissenting, in Texas v. Florida, 306 U.S. 398, 431 (1939).

tax avoidance was a horse of a different color. "When the law draws a line," he said, "a case is on one side of it or the other, and if on the safe side it is none the worse legally that a party has availed himself to the full of what the law permits." [4] On another occasion Justice Holmes added the thought: "The fact that it desired to evade the law, as it is called, is immaterial, because the very meaning of a line in the law is that you intentionally may go as close to it as you can if you do not pass it. . . . It is a matter of proximity and degree as to which minds will differ. . . ." [5] . . .

I do not mean to give blanket sanction to the many tax avoidance schemes that are constantly being presented to tax advisers. Above all things, a tax attorney must be an indefatigable skeptic; he must discount everything he hears and reads. The market place abounds with unsound avoidance schemes which will not stand the test of objective analysis and litigation. The escaped tax, a favorite topic of conversation at the best clubs and the most sumptuous pleasure resorts, expands with repetition into fantastic legends. But clients want opinions with happy endings, and he smiles best who smiles last. It is wiser to state misgivings at the beginning than to have to acknowledge them ungracefully at the end. The tax adviser has, therefore, to spend a large part of his time advising against schemes of this character. I sometimes think that the most important word in his vocabulary is "No;" certainly he must frequently use this word more emphatically when it will be an unwelcome answer to a valuable client, and even when he knows that the client may shop for a more welcome answer in other offices which are more interested in pleasing clients than they are in rendering sound opinions. . . .

The tax lawyer should put aside private disagreements with Congressional and Treasury policies [when advising clients]. His own notions of policy, and his personal view of what the law should be, are irrelevant. The job entrusted to him by his client is to use all his learning and ability to protect his client's rights, not to help in the process of promoting a better tax system. The tax lawyer need not accept his client's economic and social opinions, but the client is paying for technical attention and undivided concentration upon his affairs. He is equally entitled to performance unfettered by his attorney's economic and social predilections.

It may be added that in tax cases the protection of a client's rights is a sufficient job for most lawyers. It is not always easy to determine the policy of tax statutes, and the private views of the lawyer may be at variance with Congressional policy. Even though the tax adviser is in violent disagreement, the client is entitled to an objective expression of views as to that policy.

These are the principles which guide me when I discuss with clients tax questions involving the minimization of tax liabilty. I do not hesitate to advise the client fully and frankly in choosing among "the oddities in tax consequences" [6] that emerge from different methods of accomplishing the same ultimate result. I will do all I can to help the client reduce his tax liability to the lowest possible legal level or save him from a greater tax liability than his transaction needs to carry. This sometimes requires a substantial modification of an originally proposed transaction and a consideration by the client of the question whether the modified transaction will sufficiently serve his business purposes. Modifications must have substance, and the client may decide that the price he has to pay is more than the projected tax saving is worth. On the other hand, he may be willing to do what is required to place the transaction on the safe side of the line

[4] Bullen v. Wisconsin, 240 U.S. 625, 630 (1916). . . .

[5] Superior Oil Co. v. Mississippi, 280 U.S. 390, 395 (1930).

[6] United States v. Cumberland Public Service Co. [supra page 676].

drawn by the statute. He is entitled to counsel which makes the outlines of his choice clear to him.

These problems frequently arise in the lives of tax attorneys when their clients seek to take advantage of the capital gain rate of tax, or when their purpose is to minimize the impact of taxation upon the family by a bona fide distribution of property to wife and children. When this happens to me, I take, as I see it, a statute the policy of which I do not personally favor; I even accept the policy of statutes which I have opposed. This is true, for example, of the stock option provision [§421], the family partnership provision [§704(e)], and the percentage depletion provision [§613]. In advising in connection with provisions of this kind, I try to be strictly on guard against overinterpreting relief provisions; but I see no reason why in my role as tax adviser I should set myself up against Congress as the arbiter of tax policy. My assignment is simply to be careful that the client does not overstep the line of policy drawn in the statute as Congress has passed it and as the Treasury and the courts have refined that line in their interpretive regulations and decisions.

Guided by these principles I feel that I am justified in recommending to a client that he transfer some of his property to a trust for the benefit of members of his family with the object of minimizing the family tax burden. The client may express a natural desire to retain as much control over the property as he can without sacrifice of the objective of shifting the tax on the income from the transferred property. As I see it, my task is to help the client without letting him venture any further than necessary into unsafe territory. In doing so I will feel no moral qualms. The problem does not involve ethical issues. My client's objective is legitimate. I often resolve some legal doubts in favor of the Government so that the client has a reasonable margin of safety. This too is my duty, but I would be derelict in the performance of my responsibility if I failed, because of moral scruples or because of disagreement with the policy of the statute, to guide the client as far as he can safely go in the direction of his desire.

Keeping to the concrete, I may sanction a plan under which a corporation with a history of recent losses acquires a profitable business so that the profits and losses of the two businesses will offset one another. When I am consulted in such a matter, my assignment is to appraise conservatively the effect of [§269], which deals with this subject, but which may not apply to the particular facts of the case presented to me. In advising with respect to the transaction my sole concern should be whether the desired result can be safely achieved. It does not concern me that as a matter of policy it might have been better if Congress had passed a more comprehensive statute eliminating this tax saving opportunity.* I frequently have to make a calculation of the risks involved in going forward with a proposed business deal. If I am not prepared to devote my undivided loyalty to the objective of gaining for the client every advantage offered by the law as it is written, I should tell him at the outset to go to some other lawyer whose allegiance to his interest will be less fractional.

Of course there are limits as to how far a tax attorney may honorably go in advising clients as to the tax effect of future transactions. He should not yield to a temptation sometimes presented when his client consults him with respect to the tax effect of a desired course of action. The suggestion may be that the contracts and other papers expressing the transaction disguise its real character so that a revenue agent will miss its tax impact when it is later presented as a consummated transaction. I hope that it is almost superfluous for me to express

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* Mr. Paul's article was written before the enactment of §382, which deals more comprehensively with this problem. — Ed.

a lack of sympathy with all techniques designed to camouflage contemplated transactions in such a way as to conceal those parts of them which may provide the basis for an assertion of tax liability. The Government is a silent partner in all business transactions and is entitled to a fair view of those transactions so that it may assert its claim of interest. One may go further by saying unequivocally that attempts at misrepresentation border on fraudulent conduct. At least it is conduct unbecoming a tax attorney.

It is easy to give illustrations of prevailing techniques of misrepresentation. One favorite device is to put a transaction into two contracts, one of which is to be shown to the Government's representatives, and the other of which is to be kept secret. This happened once in my experience in connection with a sale of stock to a buyer for about $5 million. Since the buyer had an option on the stock of about $3 million, it was obvious that $2 million was being paid for an agreement not to compete. A payment for this covenant would have been ordinary income and not capital gain [supra page 574]. The seller insisted that this transaction be put in two documents, one which would recite the sale of stock for $5 million, and the other of which would provide against competition without mentioning any consideration. I felt obliged to refuse to be an adviser in this transaction. As a result, my client, who had reluctantly agreed because of anxiety to procure the stock, went to another attorney who was willing to let the client do what the seller wished. The client never came to me with his subsequent problems.

The ingenuity of fertile-minded clients and fringe tax advisers has devised many dubious methods of tax avoidance. The president of a family corporation may ask his lawyer if it is all right to minimize corporate tax liability by making his wife vice-president of the corporation and payng her a substantal salary, even though she performs no services whatever for the corporation. Some businessmen, in an attempt to become members of what Life calls "the expense account aristocracy," may seek arrangements under which they receive a substantial fixed allowance for miscellaneous entertainment and promotional expenses greatly exceeding the amount they expect to spend for those expenses. The argument is usually made that others in the same business engage in similar practices. It is hardly necessary to say that this is no argument at all, yet it is one which appeals to some clients.

Representing the Client

We come now to a more difficult problem area. In the law generally the antagonists in controversies are private citizens. Here a lawyer's duty to his client is paramount and exclusive. The client has put a special trust in his lawyer; the lawyer owes the client a sacred duty. "The office of attorney does not permit, much less does it demand of him for any client, violation of law or any manner of fraud or chicane. He must obey his own conscience and not that of his client." But a lawyer's devotion to the interest of his client must be entire and unadulterated. The lawyer owes his client "warm zeal in the maintenance and defense of his rights and the exertion of his utmost learning and ability." [7] He is not

[7] Canons of Professional Ethics, Canon 15. It has been suggested that lawyers are dedicated to a code of ethics which transcends the code of law. Hellerstein, Ethical Problems of Tax Practitioners, 8 Tax L. Rev. 1, 5 (1952). Mr. Hellerstein quotes James, The Professional Ideals of the Lawyer 4 (1925), who in turn quotes Henry Wade Rogers as saying: "A lawyer is unworthy of membership in the profession who would regulate his conduct solely according to what the law permits rather than what morality and honor require." But what about the lawyer's duty to secure for his client what the law permits? Should not his conduct be regulated by that requirement?

representing himself, but is acting vicariously. He must treat his client better than he treats other people. This may, indeed, as Charles P. Curtis has suggested,[8] involve lower standards of conduct toward outsiders than toward his client. No attorney in general practice can be intellectually impartial or maintain complete equilibrium of judgment; he is a partisan advocate. His first rule of conduct must be to protect to the full extent of his ability the position he is engaged to maintain.

In tax law the adversary of the taxpayer is his own, and the tax adviser's own, Government. The tax lawyer is licensed to practice before the bar of the Treasury which is his opponent. It is sometimes urged that a taxpayer's citizen relationship to his Government is not comparable to that of a plaintiff or a defendant to his adversary in an ordinary law suit and that the citizen owes his Government and his neighbors the duty of paying his share of taxes as required by law. It follows, according to this argument, that tax lawyers, as ministers of law, cannot countenance or be accessory to an escape by taxpayers of their duty to their Government. The conclusion of the argument is that the tax practitioner has a "dual responsibility." He must serve two masters. He must be loyal to his client, but he is also duty bound to the Government to see that his client does not "avoid his just share of the tax burden except by positive command of law. . . ." Almost invariably the proponents of this argument quote Holmes' aphorism: "Men must turn square corners when they deal with the government."

The argument mentioned also develops the point that the responsibility of the tax lawyer in connection with the preparation of returns and in the conduct of a case within the Treasury lodges in certain additional circumstances which are peculiar to tax controversies. To a considerable extent Government representatives depend upon facts presented to them by the taxpayer. While the Government has every power to inspect taxpayers' records and examine the taxpayer and others who have knowledge of transactions needing scrutiny, this power is in many respects more theoretical than real. In the normal case even the revenue agent who makes an examination of the taxpayer's records cannot examine every item in those records; if he did, he would never finish his job. He must to some extent depend upon the taxpayer or the taxpayer's lawyer or accountant to make the relevant data or facts available. This control over the facts of a controversy by the taxpayer sometimes makes deception an easy matter for the tax attorney who is willing to take advantage of the Government.

Moreover, the lawyer of accepted reputation soon comes to find, and should be particularly conscious of the fact, that Government representatives sometimes rely to a marked degree upon his integrity. On occasion they accept without minute examination or meticulous scrutiny statements of facts presented to them by an attorney they trust. They may assume that statements presented comprise all the facts. In doing so they are to some degree depending upon the tax adviser's sense of candor and fairness. This tendency on the part of some Government representatives puts a load of special responsibility upon the tax adviser. Some clients are willing, sometimes innocently and sometimes deliberately, to trade upon their lawyer's good reputation. Lawyers whose word is their bond have a special obligation to be diligent in their analysis of the facts involved in tax controversies and scrupulously careful that their factual presentations to Government representatives fairly reflect the truth.

I have also heard the additional argument that since the success of the income, estate and gift taxes depends in such large degree upon the co-operation of taxpayers, an understanding by them of the revenue necessities of the country is in-

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[8] Curtis, The Ethics of Advocacy, 4 Stan. L. Rev. 1, 5 (1951).

evitably required. Certainly it is true that the American federal tax system cannot rely solely upon enforcement; the maintenance of a co-operative public attitude is of the utmost importance to the success of that system. Between 80 million and 90 million returns pour annually into the Bureau of Internal Revenue. The Bureau employs only about 20,000 revenue agents, deputy collectors, and auditors. These Bureau representatives manage to examine approximately 4 million returns each year, or less than one of every 20 filed. In that process each Bureau representative examines an average of 200 returns a year.* Even a superficial examination ordinarily involves checking many details reported on the return, conferences with the taxpayer, an examination of his personal records or books of account, and the preparation of a report on the examination made.

The more thorough examinations required in more complicated cases may entail such further activities as checking the taxpayer's business inventory, verifying his travel and entertainment expenses, interrogating business associates and parties to transactions with the taxpayer, and many other time-consuming activities. To be even reasonably sure that the taxpayer has not failed to report taxable income, or that he has not overstated his allowable deductions, the examining agent must check bank records, stockbroker records, and many other sources of information. No revenue agent can, or does, conduct 200 thorough examinations per year. Only a few taxpayers ever undergo a complete examination; as to the rest, there can be little more than a token, or spot-check, enforcement.

If tax advisers have special responsibilities of the sort described, the Treasury Department has been far from prodigal about their articulation. The Act of July 7, 1884 [23 Stat. 258] gives to the Secretary of the Treasury the right to prescribe rules and regulations governing the recognition of attorneys and agents representing claimants before his Department. He may require that attorneys practicing before his Department show that they are of "good character and in good repute," and that they are "possessed of the necessary qualifications" to enable them to render valuable service and are otherwise "competent to advise and assist" claimants in the preparation of their cases. Under Treasury Department Circular 230 every enrolled person must conduct his practice "in an ethical and professional manner," and it is his duty "to observe the canons of ethics as adopted by the American Bar Association." Agents other than attorneys must observe the ethical standards of the accounting profession. When they accept a Treasury card evidencing their right to practice before the Bureau of Internal Revenue, enrolled attorneys also agree to obey a number of commands set forth in Circular 230, among which are the following:

§10.22 Information to be furnished. — (a) To the Internal Revenue Service generally. — No enrolled attorney or agent shall neglect or refuse to submit records or information in any matter before the Internal Revenue Service, upon proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, unless the information or testimony is privileged or such attorney or agent has reasonable grounds to believe and does believe that the said demand is of doubtful legality; and no such attorney or agent shall interfere, or attempt to interfere, with any proper and lawful efforts by the Internal Revenue Service or its officers or employees to obtain information relative to any matter before the Internal Revenue Service. . . .

§10.23 Knowledge of client's omission. — Each enrolled attorney or agent who knows that a client has not complied with the law, or has made an error in or omission from any return, document, affidavit, or other paper which the client is required by law to execute in connection with any matter administered by the Internal Revenue Service, shall advise the client promptly of the fact of such noncompliance, error, or omission.

* These statistics reflected the Internal Revenue Service's workload as of 1950-1952, but the order of magnitude has not changed significantly since then. — Ed.

§10.24 Diligence as to accuracy. — (a) In general. — Each enrolled attorney or agent shall exercise due diligence in preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to Internal Revenue Service matters.

(b) Representations to service. — Each enrolled attorney or agent shall exercise due diligence to determine the correctness of representations made by him to the Internal Revenue Service.

(c) Representations to clients. — Each enrolled attorney or agent shall exercise due diligence to determine the correctness of representations made by him to clients with reference to any matter administered by the Internal Revenue Service.*

Do the above quoted requirements, in combination with the assumptions implicit in the structure of the American revenue system and the established procedures for the disposition of tax disputes short of resort to the courts, provide a standard of conduct different from that which binds the general practitioner representing clients in private litigations? Do they place the tax adviser in a position of "dual responsibility," which dilutes the supreme duty he owes to his client? Do the stated rules and assumptions demand more meticulous conduct than is required of attorneys when they try cases in the Tax Court or other courts having jurisdiction of tax cases? Many, of whom I am one, have asserted that they do. Yet the answer to these questions is far from clear, and strict analysis requires admissions of doubts. This is not to deprecate the need of a high standard of ethics in the practice of tax law. The question is whether the standards applicable to the conduct of attorneys representing clients before the Bureau of Internal Revenue vary from those which are applicable to attorneys engaged in general practice, and place upon the former a responsibility on certain occasions to put the interest of the Treasury in a position paramount to the interest of their clients.

Those who urge a double standard of ethics have cited examples in their discussion of the ethics of tax practice. It is always healthy to test general propositions by getting down to concrete cases. In [a symposium on Ethical Problems of Tax Practitioners, published in 8 Tax L. Rev. 1 (1952)], Mr. Hellerstein mentioned the case of Mr. Brown, an officer of a small closely held corporation, who wanted to imitate the conduct of his neighbor, Jones, "a fine upstanding citizen." Jones, who made generous contributions to deductible charities, told Brown that he had his personal automobile, which he never used in the business, purchased, owned, serviced and insured by his corporation.

In the same symposium Thomas N. Tarleau presented two further questions. One involved depreciation on property inherited by the taxpayer which, he told his adviser, had been converted to a business use shortly after its inheritance ten years before the taxable year. The property had been rented or held out for rent for a considerable period, and it was possible to show a substantial value on the date of conversion. The Treasury representative before whom the case was being argued on protest seemed to be convinced, and asked for some supporting information. In the course of assembling this information the lawyer learned for the first time that while the real estate was still held by the taxpayer, the building actually had been torn down prior to the taxable year. The question was whether the taxpayer's lawyer was required to suggest to the agent that the depreciation should be disallowed.

In another question presented by Mr. Tarleau, a taxpayer consulted his lawyer about the deductibility of certain European traveling expenses incurred on a trip made for the purpose of purchasing merchandise to be resold in the taxpayer's

* Provisions of Department Circular 230 as of January 1, 1964, have been substituted for the 1952 provisions quoted by Mr. Paul. — Ed.

business. The items of expense for steamship and railroad fares, and the hotel charges and like items, appeared to be reasonable in amount. However, the lawyer's investigation uncovered the fact that the taxpayer's wife, who had no connection whatsoever with the business, had accompanied the taxpayer on the trip. The charges covered her transportation and hotel expenses. The question submitted was whether the lawyer was required to disclose to the Treasury agent that part of the traveling expenses was for the taxpayer's wife.

I doubt if any reputable tax practitioner would have any trouble with these cases. He would promptly tell Mr. Brown that the conduct of his neighbor, Jones, was highly questionable. He would unhesitantly advise the Bureau that the building had been torn down in a year previous to the taxable year and admit that his client was entitled to no depreciation whatever. Under the circumstances stated he would refuse to sanction the deduction of the wife's expenses on the European trip.

But, unfortunately, these cases do not help very much in the disposition of the question under discussion. I would guess that most reputable tax attorneys would not undertake to defend the proposed conduct of these taxpayers before the Tax Court or any other court. I would also be doubtful whether most attorneys in general practice would be willing to represent clients whose position on the facts was so indefensible as it was in these cases. The cases therefore furnish no basis for any firm rule that a tax adviser in appearing before the Bureau assumes some load of responsibility to the Government which is not present when he represents a client in private litigation.

We may perhaps find the answer to our question in some more difficult examples. Mr. Hellerstein submitted a question involving the settlor of a trust, the income of which his tax lawyer was fearful might be taxable to him under the *Clifford* doctrine and regulations. However, the issue was in doubt. He also submitted a question involving interest payments on notes held pro rata by the stockholders of a corporation which might be attacked under the so-called "thin incorporation" doctrine. In these two cases it was clear that the Bureau would decide the issue adversely to the client if the facts were brought to the Bureau's attention, though it was not clear what the result would be if the question went to litigation. Should the tax practitioner insist upon a full disclosure, advising the client to set forth in his return all the facts relating to the *Clifford* question? Should he advise the corporation to call attention in its return to the circumstances of "thin incorporation," so that the issue would not be overlooked by the Bureau? Or should the tax adviser resolve these questions in the taxpayer's favor and advise him not to flag them in the return?

These questions are not easily answered. Mr. Hellerstein concluded that most tax practitioners would not advise disclosure, but would go along hoping "with some anxiety, but with no feeling of guilt, that the revenue agent would miss the item." "It is the ethic of the profession," Mr. Hellerstein regretfully concluded, that "the tax practitioner does not regard it as his duty to recommend full and fair disclosure of the facts as to items questionable in law."

This may be true as to the particular illustrations given. The *Clifford* doctrine is a thicket of obscurity, and there is no yardstick for the measurement of the "thin incorporation" doctrine. There are, however, cases in which there is a clear duty of disclosure which most tax attorneys would respect. For instance, in spite of the *Textile Mills* decision and the applicable regulation, there remains some chance that legitimate lobbying expenses are deductible.* Yet I think most

* Textile Mills Securities Corp. v. Commissioner, 314 U.S. 326 (1941). For later developments, see pages 283-284 supra. — ED.

tax attorneys would refuse to sanction the deduction of lobbying expenses in a return without a complete segregation of the deduction so that it would automatically come to the attention of the revenue agent. At the other end of the spectrum, in some areas of the tax law the Bureau of Internal Revenue has adopted a policy of persistent litigation of questions which have been repeatedly decided favorably to taxpayers by the Tax Court and by the Courts of Appeal in several circuits. Here the average tax attorney would, I think, advise a client that he need not flag an item in his return because his position was supported by a number of authoritative and carefully reasoned court opinions. Between these two poles many borderline problems constantly arise to plague tax advisers.

Similar problems confront the tax adviser in the presentation of the taxpayer's position within the Bureau of Internal Revenue on protest or before the Appellate Staff. Of course, a tax lawyer should respond truthfully to questions asked by Government representatives about the facts of the case he is presenting; "in his intercourse with those in authority . . . touching the performance of their functions, he is bound to exhibit truth, frankness, and integrity." As Circular 230 indicates, he "must exercise due diligence in preparing financial statements for clients and in certifying to the correctness of the same." He should not "neglect or refuse to produce records or affidavits in any matter before the Treasury Department upon proper and lawful demand," unless he has reasonable grounds to believe, and does believe, that the demand is of doubtful legality. He should not interfere with any proper and lawful efforts of the Bureau to procure information Government representatives believe to be relevant to the Government's side of the case. He must exercise due diligence "in preparing or assisting in the preparation of, approving, and filing returns, documents, affidavits, and other papers relating to Treasury Department matters."

We have gone so far as to require a tax adviser to inform Government representatives as to points of fact which completely dispose of the taxpayer's case. We have also suggested the obligation upon tax attorneys to supply truthful answers to all questions asked by the Government representatives. I certainly agree generally with Mr. Tarleau that tax advisers should "engage in open-handed dealing," and "avoid anything suggesting concealment or trickery." But are they obliged "to reveal every fundamental fact which is pertinent to the issue under consideration?" What if the Government representatives fail to make a specific request for certain information in the possession of the tax attorney which is harmful to, but not dispositive of, a taxpayer's case? To what extent is the tax attorney obliged to volunteer information at such a time? Must he turn over every item of information in his possession irrespective of the effect of doing so upon his client's case? If the answer to this question should be in the affirmative, I am sure that we have found a substantial difference between the position of attorneys representing clients in private litigation and attorneys representing taxpayers before the Bureau of Internal Revenue.

I can give no definitive answer to the questions I have just asked. There are times when a failure to speak may be a misrepresentation. But I will venture the statement that most tax attorneys would rarely volunteer information under the circumstances stated. And I would be the last to condemn them for not doing so.[9] I would not know how to answer their argument that except where

[9] Samuel Williston would not condemn him. "The lawyer must decide when he takes a case whether it is a suitable one for him to undertake and after this decision is made, he is not justified in turning against his client by exposing injurious evidence entrusted to him. . . . [D]oing something intrinsically regrettable, because the only alternative involves worse consequences, is a necessity in every profession." Williston's autobiography tells of one of his early cases which illustrates the difficulties involved in this type of situation. Williston's client was sued in a finan-

the rules of practice dictate otherwise tax proceedings in the Treasury are predominantly adversary proceedings calling for no higher ethical standards than those imposed upon attorneys engaged in general practice. At times one encounters a revenue agent or a conferee who is genuinely interested in ascertaining the taxpayer's correct tax liability wherever the chips may fall. But this is the exception rather than the rule. Treasury representatives are subject to many pressures, and as a rule their conduct closely resembles the conduct of attorneys in private litigation. They put the most favorable face upon the facts supporting the Treasury side of the controversy, as taxpayers do upon the facts supporting their side; and they argue, sometimes with considerable vehemence, that the precedents require a conclusion in favor of the Government. Certainly they are not, and do not pretend to be, acting as impartial referees. I do not say that they should. They are servants of a Government which needs revenue badly, and they would be more than human if they were not at least a little partisan on behalf of that Government. All these considerations lead to doubt whether the tax attorney has a responsibility to the Treasury over and above the responsibilities enumerated in Department Circular 230 and those described in the Canons of Ethics which are incorporated by reference in that Circular.

Whatever special rules may apply to the conduct of a case before the Treasury, it seems clear enough that they cease to apply when a civil tax case reaches the litigation stage, either in the Tax Court, the federal district court, or the Court of Claims. Like other "legal battles fought in a court room," these proceedings are "fights." The parties, one of which is the Government, are in a law suit which does not differ in any essential respect from any other law suit. A judge is in charge of the trial, and counsel for both sides are functioning as advocates. The Government has full power to investigate the facts underlying its case. It may call witnesses to testify to those facts and it may cross-examine the taxpayer's witnesses. It has the advantage involved in a presumption of correctness for the deficiency letter and all findings made by the Bureau of Internal Revenue. The taxpayer generally has the burden of proof. No special Treasury rules impose any inhibitions upon the conduct of his attorney. I do not see that the taxpayer's attorney has any obligation affirmatively to present facts hostile to his client's case. He may do so to minimize the impact of the adverse facts upon the judgment of the court if they should be presented by the other side. But here, again, the problem is one of judgment, not of ethics, and the attorney for the taxpayer certainly has no obligation to present the other side's case. He may be obliged to submit to judgment against his client if he knows some critical fact which completely disposes of the case, but he is certainly not required to submit evidence which merely points in the direction of judgment for the Government.

There is general agreement among tax attorneys, I think, that no special rules apply to the conduct of criminal fraud cases. These cases are primarily criminal cases involving taxes and not tax cases involving criminal law. The question is whether the taxpayer is to be charged with a crime. His liberty, as well as his property, is in peril. On the basis of independent investigation by its agents the Government is asking the question whether the taxpayer is guilty of wilful failure

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cial matter. Williston at once went through his letter file painstakingly, sorting and collating it. As the trial approached, the plaintiff's lawyers did not demand to see the correspondence or ask for its production. Williston states that he did not feel bound to disclose the correspondence. At the close of the trial in the course of the remarks the Chief Justice stated as a reason for his decision a supposed fact which Williston knew to be unfounded. He had in front of him a letter showing the Judge's error. Williston says: "Though I have no doubt of the propriety of my behavior in keeping silent, I was somewhat uncomfortable at the time." Williston, Life and Law 271 (1940).

to report his correct tax liability. The facts leading to investigation are not usually facts disclosed in the taxpayer's return; indeed, they are usually facts not there disclosed. The Government rarely reveals the evidence upon which it proposes to base its charge; in fact, some Government attorneys seem at times zealous to preserve a degree of secrecy which will enable the Government to surprise the defendant at the trial of the case. Of course the Government has the burden of proving the crime beyond a reasonable doubt. But in assembling its proof the Government does not to any marked degree rely on representations made by the taxpayer's attorney; on the contrary, it specifically assumes the responsibility of gathering its own information. Under these circumstances the tax attorney owes the Government no duty beyond the obligation not to present what he knows to be untrue. His duty to his client is undivided and he need not disclose any information not to his client's advantage. This type of case may even present a duty to advise the client not to co-operate with the Government, but to place upon the Government the whole burden of investigation. Under the Fifth Amendment to the Constitution a fraudulent taxpayer cannot be compelled to be a "witness against himself."

Another question sometimes arising in the doubting minds of tax attorneys is whether they are free at all stages of a tax controversy to make legal arguments in which they do not sincerely believe. Should they discard arguments that do not persuade them and restrict their advocacy to the arguments they personally believe to be sound? Some will say that the question is academic because of the propensity of lawyers to achieve convictions on the side of any cause in which they are engaged. Brandeis once said that "the lawyer is not often harassed by this problem partly because he is apt to believe at the time in most of the cases he actually tries, and partly because he either abandons or settles a large number of cases he does not believe in." But this capacity for "self-sown sincerity" is not unlimited, and the question I raise needs an answer.

In its most acute form this question arises in criminal cases in which the lawyer is representing a client he knows to be guilty. But the same essential question may confront the tax lawyer representing a client who in the belief of the lawyer owes the tax asserted by the Government. The same question arises in a reduced degree when several arguments present themselves to the mind of the tax lawyer, some of which he believes to be good arguments and some of which are unconvincing to him. Should he cast aside the arguments which do not persuade him, and urge upon the Treasury and the courts only those in which he does believe?

The classical solution of this problem was suggested a long time ago by Dr. Johnson. Boswell asked Johnson what he thought of "supporting a cause which you know to be bad." Johnson answered:

> Sir, you do not know it to be good or bad till the Judge determines it. I have said that you are to state facts fairly; so that your thinking, or what you call knowing, a cause to be bad, must be from reasoning, must be from your supposing your arguments to be weak and inconclusive. But, Sir, that is not enough. An argument which does not convince yourself, may convince the Judge to whom you urge it: and if it does convince him, why, then, Sir, you are wrong, and he is right.

My answer would be to much the same effect. A tax lawyer's judgment may dictate that it would better serve his client not to present an argument which will do worse than fall flat by implying that he has no better argument. But ethics do not require him to discard any arguments. As I have indicated, once he has taken a case, the tax lawyer is obliged to present arguments even though they may contribute to tax avoidance or conflict with his own notions of what the law should be. Equally, he had better not cast away an argument just because it is not con-

vincing to him. That may be the very argument which would persuade the Government representative or a judge to decide the case in his favor. It is no objection to an argument that the lawyer has to put his tongue in his cheek when he presents it; "a lawyer is required to be disingenuous." Advocacy requires a certain capacity for insincerity. A tax lawyer need not believe in every argument he presents. In the first place, he may not know whether or not it is valid, or what he thinks he knows may be wrong; Omar Khayyám anticipated tax law when he observed: "a hair perhaps divides the False and True." In the second place, an advocate is engaged to dissemble, to pretend; the legal profession and our prevailing system of advocacy make a virtue of some capacities which may on other occasions be vices. The tax lawyer would be breaching his duty to his client if he indulged a sensitivity of conscience which has a higher place in other contexts than it has in a system of law which acts "under the impression that truth is best discovered by powerful statements on both sides of the question."

Representing Broader Interests

As I come to the end of this inconclusive discussion of the ethics of tax advocacy, I find myself wanting to be sure that the reader does not misunderstand my attitude upon one point. I have argued that a tax lawyer should be careful not to let his private notions of fiscal policy intrude into work for a client on a tax case except as his knowledge of policy considerations may help him the more intelligently to represent the client. But I do not want anyone to infer from this discussion that I object to participation by tax advisers in efforts looking to the improvement of tax law. I feel strongly to the contrary. To me it is one of the tragedies of the time that tax advisers do not use more generally for their Government, as well as for their clients, the special knowledge their education and experience have bestowed upon them. I think that they should use this knowledge actively, affirmatively, and even aggressively. The country most sorely needs the contribution they are so well qualified to make to the serious problems the Government faces at home because of its obligation to take a leading part in international affairs.

The tax adviser is not disqualified from activity on this front because he represents taxpayers. The shoe is on the other foot. The representation of taxpayers gives to tax advisers the experience that theory always needs if it is to ripen into maturity. It teaches them what will work in practice, as distinguished from what looks good on paper. It enriches the whole outlook of tax advisers, and makes their advice to their Government more realistic and dependable. It makes them all the more qualified to express a constructive opinion about what is wrong with tax law and what should be done to improve the tax system. On the other hand, it is necessary to be on guard against a tendency to assume that what is best for clients is best for the United States. Much representation of clients sometimes makes lawyers captives of their clients' opinions, and an analysis of many tax betterment proposals from tax lawyers quickly reveals that the lawyers are promoting the special interests of their clients. A tax lawyer needs to preserve an independence of outlook, unclouded by prejudices acquired from his clients. His clients do not always know what is good for them, and there is a sense in which what is good for the United States is good for clients.

No doubt some tax lawyers feel constrained to abstain from activities on behalf of a better tax system because they think that their clients may object. Clients have no right to object if the tax adviser handles their affairs competently and faithfully and independently of his private views as to tax policy. They buy his expert services, not his private opinions or his silence on issues that gravely affect the public interest.

I suspect that the thinking of some tax advisers exaggerates the objections clients have to activities on behalf of improvement in the tax system. It is true, as Adams once observed, that taxation is "a group contest in which powerful interests vigorously endeavor to rid themselves of present or proposed tax burdens," and that "class politics" is of its essence. But more and more in recent years there has developed in businessmen, and that wealthier segment of the population which furnishes tax clients, a realization of the need of more expert attention to the tax problems than can come from persons within the Government. It is one encouraging sign of the times that taxes have captured the interest of a wide public. Sometimes that interest expresses itself in pressure politics and propaganda, and attempts to advance the cause of the few at the expense of the many. But objectivity is also spreading its more wholesome influence. At least, it is no longer a mark of condemnation of a tax adviser that he serves his country on the tax front.*

NOTE

1. *The taxpayer's responsibilities.* If a taxpayer's adviser tells him that a receipt is excludable from gross income in the adviser's opinion, but that the question is debatable, does the taxpayer have an obligation to explain on his return that he has omitted the item? If he takes a debatable deduction, ought he to label it so that an overworked revenue agent, thumbing rapidly through a pile of returns, will stop short at his? Does the taxpayer in such a case have a heavier moral obligation if his taxable income is so small that his return will probably otherwise escape notice?

Are we our brother's keepers? Suppose a physician is asked by Mrs. Smith to bill her husband's corporation for services rendered to her. Is he entitled to assume that the corporation, on paying the bill, will charge the amount to Mr. Smith's salary or personal account rather than deduct it as a business expense? What if Mrs. Smith asks that the bill make no reference to the fact that she was the patient?

2. *Responsibilities of the government employee.* What are the responsibilities of the government employee in tax matters? May the taxpayer assistance unit, in advising taxpayers on the preparation of their returns, properly assume that the Internal Revenue Service's rulings are the final authority, or should the taxpayer be informed that a particular ruling has been disregarded by the courts though the Service continues to adhere to it? If reliable information received from one taxpayer establishes the right of another taxpayer to a tax allowance (e.g., the husband's right to a dependency exemption for children in his divorced wife's custody), is it proper for the government to deny the allowance, either administratively or in the courts, on the ground that the second taxpayer has not met his burden of proof? Are government attorneys bound by the canons of professional ethics? Can they rely conclusively on the orders of their superiors in tax matters? See 16 Bulletin of A.B.A. Section of Taxation 273-274 (1963).

3. *"Tax practice" as the practice of law.* If an accountant, in the course of preparing a tax return for a client, reads §74, the Regulations, and some cases in order to decide whether a sum of money should be reported as a taxable prize or excluded from gross income, has he engaged in the practice of law? What if he advises a client for whom he regularly performs accounting services that its taxes on the sale of property can be reduced by selling it on the installment plan, having first read some cases and rulings to resolve ambiguities in the language of §453? If this is permissible, would the result be different if the same services were performed for a client who came to an accounting firm solely for this advice, or if the firm had on its staff an attorney (or an accountant who had gone to law school but was not admitted to practice as an attorney) who concerned himself exclusively with such problems? See In re Bercu, 273 App. Div. 524, 78 N.Y.S.2d 209, affirmed without opinion, 299 N.Y. 728 (1948) (certified public accountant advised client on the proper year to deduct city taxes, after examination of cases and rulings; held, unauthorized practice of law):

* Mr. Paul suffered a heart attack and died while testifying in the public interest before the Joint Committee on the Economic Report. Warm tributes to his career may be found in the Congressional Record for February 6 and 7, 1956, pp. 1799-1801 and 1859-1860. — Ed.

We must either admit frankly that taxation is a hybrid of law and accounting and, as a matter of practical administration, permit accountants to practice tax law, or, also as a matter of practical administration, while allowing the accountant jurisdiction of incidental questions of law which may arise in connection with auditing books or preparing tax returns, deny him the right as a consultant to give legal advice. We are of the opinion that the latter alternative accords to the accountant all necessary and desirable latitude and that nothing less would accord to the public the protection that is necessary when it seeks legal advice.

Respondent is most persuasive when he challenges the consistency of recognizing an accountant's right to prepare income tax returns while denying him the right to give income tax advice. As respondent says, precisely the same question may at one time arise during the preparation of an income tax return and at another time serve as the subject of a request for advice by a client. The difference is that in the one case the accountant is dealing with a question of law which is only incidental to preparing a tax return and in the other case he is addressing himself to a question of law alone.

The preparation of an income tax return is not primarily a matter of law and generally and mainly is not a matter of law. It may usually be prepared by one having no legal knowledge, from instructions prepared for lay consumption, or by one having only incidental legal knowledge. A taxpayer should not be required, therefore, and is not required, to go to a lawyer to have a tax return prepared. It is a practical, reasonable and proper accommodation to business men and the accounting profession not only to permit accountants to prepare tax returns but to permit them, despite the risks involved, to assume jurisdiction of the incidental legal questions that may arise in connection with preparing tax returns. It is quite another thing to say that apart from preparing a tax return and from doing the accounting work in connection with the return, and accountant should be permitted as an independent consultant to pass upon specific questions which are questions of law, especially when the occasion for such consultation is apt to be, as it was in this case, a particularly knotty question of law. The distinction is altogether valid and desirable. The law here, as elsewhere, is a rational and practical adjustment of conflicting interests, objectively calculated to be of the greatest public benefit.

For a stricter approach, see Gardner v. Conway, 234 Minn. 468, 48 N.W.2d 788 (1951) (in preparing a tax return for a client, an accountant who described himself as an "income tax expert" and "tax consultant" advised on family partnership problem, use of joint return with common law spouse, etc.; held, accountant or other layman may not hold himself out as "tax consultant" or resolve "difficult or doubtful questions of the interpretation or application of statutes, administrative regulations and rulings, court decisions, or general law" even in preparation of a tax return); see also Anchin, Block & Anchin v. Pennsylvania Coal & Coke Corp., discussed in 3 J. Taxation 83 (1955) (another aspect of this litigation is reported at 134 N.Y.S.2d 737).

As to the custom in this area, see Bancroft v. Indemnity Insurance Co., 203 F. Supp. 49, 56 (W.D. La. 1962), holding that an insurance company was liable under an accountants' professional liability policy for loss caused to a taxpayer by bad advice (failure to take account of §304, supra page 659, in advising on the tax consequences of a sale of stock to a related corporation). In answer to the defendant insurance company's argument that the loss was not within the terms of the policy because the insured was pro tanto engaged in the unauthorized practice of law, the court said that it would take judicial notice "of the fact that in Monroe, Louisiana, as elsewhere, C.P.A.'s regularly render opinions and advise their clients on matters of federal and state income tax liability as a routine matter in performance of their professional duties," that lawyers frequently refer their clients to accountants for such advice, and that knowledge of "this almost universal practice" could be imputed to the defendant. Query: if an accountant's activity would otherwise constitute the unauthorized practice of law, is it excused by the fact that the client is referred to the accountant by his attorney, or by the fact that the services are rendered by the accountant to the attorney?

There have been a number of negotiations between the American Bar Association and

the American Institute of Certified Public Accountants in an effort to avoid or resolve attorney-accountant conflicts in this area, and these groups have created a National Conference of Lawyers and Certified Public Accountants which issued a Joint Statement of Principles in 1951. 37 A.B.A.J. 517 (1951). What is, or should be, the relation between this National Conference and non-certified accountants and others who seek to prepare tax returns, advise clients, or perform similar services for a fee?

4. *Treasury enrollment.* Persons who wish to practice before the Treasury Department (e.g., representing taxpayers in disputes with revenue agents or before the Appellate Division) must be enrolled under Treasury Department Circular 230, discussed by Paul, supra page 976. A "Treasury card" is issued to an attorney or certified public accountant upon a showing that he is in good professional standing in his state; other persons must pass a written examination. Treasury Circular 230 provides that practice before the Treasury Department "shall be deemed to comprehend all matters connected with the presentation of a client's interest," and that an enrolled agent shall have the same rights as an enrolled attorney:

> Provided, That an enrolled agent shall not have the privilege of drafting or preparing any written instrument by which title to real or personal property may be conveyed or transferred for the purpose of affecting Federal taxes, nor shall such enrolled agent advise a client as to the legal sufficiency of such an instrument or its legal effect upon the Federal taxes of such client: And provided further, That nothing in the regulations in this part shall be construed as authorizing persons not members of the bar to practice law.

Does this proviso bow entirely to local law concepts on the unauthorized practice of law, or is it a springboard for creating a federal standard? In Agran v. Shapiro, 127 Cal. App. 2d 807, 273 P.2d 619 (1954), a certified public accountant sued a client to collect a fee for representing him in negotiations with a revenue agent on his right to a net operating loss, the services including five days' research in the county law library. Following Gardner v. Conway, supra, the court held that the accountant's activities constituted the unauthorized practice of law, and said that the proviso of Treasury Circular 230 quoted above "could only have been intended as a disavowal of any intent upon the part of the Secretary of the Treasury to confer authority upon enrolled agents, not members of the bar, to perform acts upon behalf of others in connection with matters before the department which would otherwise constitute the practice of law." A further opinion in Agran v. Shapiro, on remand to the trial court, is reprinted in 3 J. Taxation 80 (1955).

In 1956, prompted by varying judicial interpretations of Circular 230, the Secretary of the Treasury issued a statement which asserted that enrolled persons, "whether agents or attorneys, have been satisfactorily fully representing clients before the Department for many years" and that "there presently appears no reason why the present scope and type of practice should not continue as it has in the past." As to the "second proviso" of Circular 230, quoted above, he said:

> It is not the intention of the Department that this second proviso should be interpreted as an election by the Department not to exercise fully its responsibility to determine the proper scope of practice by enrolled agents and attorneys before the Department. It should be equally clear that the Department does not have the responsibility nor the authority to regulate the professional activities of lawyers and accountants beyond the scope of their practice before the Department as defined in §10.2(b) and nothing in Circular 230 is so intended.

On the power of Congress to pre-empt the field of standards for practice before a federal agency, see Sperry v. Florida, 373 U.S. 379 (1963) (Patent Office's licensure procedures for patent agents preclude state requirement of admission to bar). In this case, the Supreme Court noted a "divergence in opinion" between Noble v. Hunt, 95 Ga. App. 804, 99 S.E.2d 345 (1957) (C.P.A. may recover fee for services in representing plaintiff in fraud matter before Treasury Department and Tax Court), on the one hand, and In re Kearney, 63 So.2d 630 (Fla. 1950) (attorney may not practice in Florida as "federal tax counsel" before Tax Court and Treasury Department without being admitted to state bar), and Agran v. Shapiro, supra, on the other.

Treasury Circular 230 exempts from enrollment certain persons, including the taxpayer himself, his full-time employees, officers of a corporation, members of the taxpayer's immediate family if serving without compensation, and trustees acting for their trusts. In 1959, exemption was extended for a person who prepared a return for the taxpayer, but only with respect to tax liability for the taxable year covered by the return, and only before revenue agents (other than conferees) of the Audit Division of the District Director's office.

5. *Practice before the Tax Court.* A "Treasury card" does not permit the holder to practice before the Tax Court, which has its own rules for admission to practice. Section 7452 provides that no "qualified person shall be denied admission to practice before the Tax Court because of his failure to be a member of any profession or calling," but persons who are not attorneys must take a written examination as a condition to admission. An announcement by the court states that the examination tests the applicant's ability to prepare "pleadings, motions, briefs, etc.," and his knowledge of legal ethics and of judicial interpretations of the Internal Revenue Code, and it has been described by Chief Judge Tietjens of the Tax Court as "a limited, or specialized bar examination." According to Judge Tietjens, "those who pass it and otherwise demonstrate acceptable qualifications are enrolled, in a sense, as lawyers with a practice limited to this Court." 1962 Annual Reports of A.B.A. 342. Rule 2 requires all practitioners before the Tax Court to carry on their practice "in accordance with the letter and spirit of the canons of professional ethics as adopted by the American Bar Association."

6. *Tax practice as a specialized calling.* Would it be desirable to recognize "tax practice" as a specialized or independent calling, to establish a training and examination procedure, and to permit attorneys and certified public accountants (or others) to hold themselves out as "tax practitioners" or "tax specialists" after meeting these special requirements? Arguing that the *Bercu* approach (supra) "merely eliminates one group — which includes many competent practitioners and some incompetent — and permits the vacuum to be filled by another — which also includes many competent practitioners and some incompetent," a commentator has proposed a Treasury enrollment procedure requiring lawyers to demonstrate enough knowledge of accounting "to act intelligently in tax matters" and accountants to demonstrate a parallel understanding of legal materials and procedures. Rembar, The Practice of Taxes, 54 Colum. L. Rev. 338 (1954). Although the House of Delegates of the American Bar Association has approved in principle the establishment of a procedure entitling lawyers to recognition as specialists in particular fields, a special committee of the A.B.A.'s Section of Taxation has expressed "serious misgivings as to whether it is possible to establish a basis of certification of special tax proficiency that would be meaningful to other lawyers, and not misleading to laymen, unless the standards were set sufficiently high so that, as a practical matter, most lawyers in the active practice in the field of taxation would be unlikely to qualify." 1962 Program and Committee Reports, A.B.A. Section of Taxation 9.

7. *References.* Ethical problems: Symposium, Ethical Problems of Tax Practitioners, 8 Tax L. Rev. 1 (1952); Darrell, Conscience and Propriety in Tax Practice, 17 N.Y.U. Inst. on Fed. Taxation 1 (1959); Johnson and Young, Does the Tax Practitioner Owe a Dual Responsibility to His Client and to the Government, 1963 So. Calif. Tax Inst. 25 and 39; Surrey, The Congress and the Tax Lobbyist — How Special Tax Provisions Get Enacted, 70 Harv. L. Rev. 1145, 1170 et seq. (1957); Brown, Responsibilities of the Taxpayer, 1963 So. Calif. Tax Inst. 1; Miller, A Taxpayer's Duty to His Fellow Taxpayers, 19 N.Y.U. Inst. on Fed. Taxation 1 (1961); Report of Special Committee on Standards of Tax Practice, 16 Bulletin of A.B.A. Section of Taxation 267 (1963); Panel Discussion, What Is Good Tax Practice, 21 N.Y.U. Inst. on Fed. Taxation 23 (1963).

Professional skills and jurisdiction: Symposium, What Makes a Successful Tax Lawyer, 7 Tax L. Rev. 9 (1951); Aland, Relations Between Lawyers and Certified Public Accountants in Federal Tax Practice, 15 Ala. L. Rev. 515 (1963); Griswold, We Can Stop the Lawyer-Accountant Conflict over Tax Practice Now: Four Recommendations, 2 J. Taxation 130 (1955), with which see comments reported at 2 id. 271 and 3 id. 336; Meldman, The Legal Responsibilities of the Person Preparing the Tax Returns and Furnishing Tax Advice and Reliance upon Advice of Counsel, 46 Marq. L. Rev. 313 (1963); Report of Special Committee on Professional Relations, 1962 A.B.A. Annual Reports 340 and Appendix 105.

PART II

Federal Estate and Gift Taxation

Introduction

The taxes that are the subject of Part II are not important sources of government revenue. The Federal Government has collected $40 to $100 billion in taxes annually since World War II; of this amount, estate and gift taxes have yielded only between $0.5 to $2.0 billion a year. With heavy commitments for arms and foreign aid in prospect for some time to come, total tax levies are not likely to be greatly reduced. But estate and gift taxes will continue to produce only a modest part of the total, and any future increases in total collections are likely to be accompanied by a decrease in the relative contribution of the estate and gift taxes. The revenue from these taxes is dwarfed not only by the enormous yields from the taxation of personal and corporate income; it is meager even by comparison with the federal taxes on alcohol and tobacco. Before World War II, estate and gift taxes contributed a larger share of total federal tax revenue than they have since, their proportion during the fiscal period 1935-1941 being about 7 per cent of the total. But during that period, total federal tax collections averaged only $5 billion per year — a low level, which, unhappily, is not likely ever to be approached again.

Raising the rates would increase the yield of the federal estate and gift taxes, but no foreseeable increase would convert them into serious competitors of the federal income tax. In fact, even if a draconic Congress were to transmute the federal estate tax into an escheat measure, taking 100 per cent of the net estate, its yield would still be only a small part of total tax revenues. Estate tax returns filed in 1961, for example, reported net estates (gross estates less allowable deductions for funeral and administration expenses, debts, charitable bequests, and so on) aggregating $9.6 billion. Outright confiscation of these estates, then, would have produced — along with a group of new Congressmen, no doubt — only about 12 per cent of total federal expenditures for that year. If the present exemption of $60,000 per estate had been allowed by the hypothetical Congress, the yield would have been reduced to about $6 billion. In the same year, federal income and excess profits taxes produced about $62 billion in revenue, and the federal taxes on alcohol and tobacco a total of more than $5.1 billion. It is not surprising, then, that when cold and hot wars have created a need for more billions in government revenue in recent years, Congress has raised these funds by increasing the income tax rates, rather than by changing the estate and gift tax schedules.

State governments, too, have looked elsewhere than to death and gift taxes to satisfy the need for funds. During the fiscal year 1962, for example, death and gift taxes produced for the states only about $0.5 billion out of about $20.6 billion

in tax collections, or about 2.5 per cent of the total; in only two states (Connecticut and New Hampshire) did the yield from these taxes represent 5 per cent or more of total collections. Their yield was relatively somewhat more important before World War II, but even then they ranked much behind collections from state taxes on retail sales, gasoline, tobacco, alcoholic beverages, and motor vehicles.

The raising of revenue, of course, is not the only function of taxation. Indeed, some taxes are not expected to produce any revenue; if the Treasury reported a sharp increase in the yields from the taxes on adulterated and renovated butter, filled cheese, firearms, or narcotics, Congress would not applaud but rather would start an investigation.

Unconstrained by a conception of taxation for revenue only, contemporary economists have stressed the contribution that taxes may make toward stabilizing the national economy.

In this view, tax policy may be a counter-cyclical weapon, deliberately employed to combat manic-depressive fluctuations of the business cycle. Thus when inflation threatens, taxation can be used to sop up excess consumer purchasing power, to discourage investment, or to encourage savings. By reducing the demand for goods and services, such tax collections would serve to moderate or prevent inflation of the price level. When unemployment develops, on the other hand, taxes can be reduced to encourage spending, thus increasing the demand for goods and services and putting men and machines back into production. The federal personal income tax is suited to these tasks, it is asserted, because the progressive rate schedule acts to increase rapidly the financial pressure on the taxpayer during a "boom," while it works equally rapidly to diminish that pressure during a recession. This characteristic has been termed "cycle-sensitivity" or, because the tax responds automatically to changes in income (without even a change in the prescribed rates), "built-in flexibility."

Just as estate and gift taxes lag far behind the income tax in the power to raise revenue, so they are far less promising as counter-cyclical instruments. To be sure, decedents' estates vary in value with changes in the price level, and therefore the progressive federal estate tax possesses a degree of "built-in flexibility." If gifts are larger during "booms," as seems likely, the gift tax yields should rise and fall with the business cycle. But the impact of gifts and inheritance on the nation's total pattern of consumption, saving, and investment cannot be great; the force that carries the threat of price inflation during full employment is the generally increased national income, not the fact that the wealth of a few persons may have been augmented to some extent by gift or inheritance. The personal income tax, with stepped-up rates if necessary, can accomplish infinitely more in the way of checking inflation than even a confiscatory estate tax.

Whatever slight counter-cyclical pressure the estate tax might exert would not be felt promptly (as in the case of an income tax withheld at the source, for example), but rather would follow sluggishly, because of an almost inevitable delay in computing and collecting the tax. Moreover, abrupt alteration of the estate tax rates discriminates unfairly among taxpayers, since the tax liability falls according to the accident of the date of death. To be sure, sharp changes in income tax rates penalize those taxpayers whose earning patterns happen to be abnormal, but these inequities are proportionately less serious than in the case of the estate tax. The incomes of most taxpayers rise and fall with the business cycle, but inheritance — if it comes at all — is likely to come only once or twice in a lifetime. An increase in the gift tax rate, on the other hand, would lose much of its effectiveness if taxpayers postponed the making of gifts in anticipation of a rate re-

duction in a downswing of the business cycle. Although an increase in income tax rates can also be vitiated to some extent by postponing or accelerating certain transactions, the danger is not as great because taxpayers generally have less control over income items than over donative transfers. It is not surprising, then, that economists have not regarded estate and gift taxes as helpful tools for stabilizing the economy at a high level of employment and production.[1]

What then is the function of these taxes, which neither raise substantial amounts of revenue nor serve to stabilize the nation's economy? The answer may be found in the history of estate and gift taxation, for the proponents of these taxes have not sought to conceal their aims.

In a 1906 message to Congress, advocating a progressive inheritance tax, President Theodore Roosevelt said:

> . . . [T]he prime object should be to put a constantly increasing burden on the inheritance of those swollen fortunes which it is certainly of no benefit to this country to perpetuate.[2]

A little earlier, in a speech on laying the cornerstone of the House of Representatives office building, he had been a bit more detailed:

> . . . I feel that we shall ultimately have to consider the adoption of some such scheme as that of a progressive tax on all fortunes, beyond a certain amount, either given in life or devised or bequeathed upon death to any individual — a tax so framed as to put it out of the power of the owner of one of these enormous fortunes to hand on more than a certain amount to any one individual; the tax, of course, to be imposed by the National and not the State Government. Such taxation should, of course, be aimed merely at the inheritance or transmission in their entirety of those fortunes swollen beyond all healthy limits.[3]

The suggestion was greeted with enthusiasm by the liberal and radical press, and with dismay and predictions of doom by more conservative commentators. Somewhat earlier, Andrew Carnegie had announced his support of increased inheritance taxation in a magazine article that attracted widespread attention, including a cordial compliment from John D. Rockefeller. Carnegie said:

> The growing disposition to tax more and more heavily large estates left at death is a cheering indication of the growth of a salutary change in public opinion. The State of Pennsylvania now takes — subject to some exceptions — one tenth of the property left by its citizens. The budget presented in the British Parliament the other day proposes to increase the death duties; and, most significant of all, the new tax is to be a graduated one. Of all forms of taxation this seems the wisest. Men who continue hoarding great sums all their lives, the proper use of which for public ends would work good to the community from which it chiefly came, should be made to feel that the community, in the form of the State, cannot thus be deprived of its proper share. By taxing estates heavily at death the State marks its condemnation of the selfish millionaire's unworthy life.
>
> It is desirable that nations should go much further in this direction. Indeed, it is difficult to set bounds to the share of a rich man's estate which should go at his death to the public through the agency of the State, and by all means such taxes should be

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[1] For an evaluation of the economic role of transfer taxation, see Harriss, Economic Effects of Estate and Gift Taxation, in Federal Tax Policy for Economic Growth and Stability, 84th Cong., 1st Sess., 855 (1955); see also Bloch, Economic Objectives of Gratuitous Transfer Taxation, 4 Nat. Tax J. 139 (1951); Eisenstein, The Rise and Decline of the Estate Tax, in Federal Tax Policy for Economic Growth and Stability, id. 819 (1955).

[2] 17 Roosevelt's Works (Memorial edition, Charles Scribner's Sons, New York, N.Y., 1925) 401, 434.

[3] 18 id. 571, 578.

graduated, beginning at nothing upon moderate sums to dependents, and increasing rapidly as the amounts swell, until of the millionaire's hoard, as of Shylock's, at least

The other half
Comes to the privy coffer of the State.

This policy would work powerfully to induce the rich man to attend to the administration of wealth during his life, which is the end that society should always have in view, as being by far the most fruitful for the people. Nor need it be feared that this policy would sap the root of enterprise and render men less anxious to accumulate, for, to the class whose ambition it is to leave great fortunes and be talked about after their death, it will attract even more attention, and, indeed, be a somewhat nobler ambition, to have enormous sums paid over to the State from their fortunes.[4]

Although these statements of Roosevelt and Carnegie, like subsequent defenses of our existing estate and gift taxes, were undoubtedly a response to the "robber baron" era of American history, they did not sound a wholly new note. Throughout the nineteenth century death taxation had been advocated primarily as an instrument for the equalization of wealth. Indeed, Jeremy Bentham had used the very phrase "equalization of fortunes"[5] and John Stuart Mill had suggested "as a possible mode of restraining the accumulation of large fortunes in the hands of those who have not earned them by exertion, a limitation of the amount which any one person should be permitted to acquire by gift, bequest, or inheritance."[6] This drive toward equalization has drawn its strength from several sources: a moralistic abhorrence of idleness or profligacy, thought to be a result of unearned wealth; the belief that the economic well-being of the community requires that all its members earn their own livings; and an ethical insistence upon equality of opportunity. No doubt these sources, and others, have contributed in different degrees to the views of individual supporters of gift and estate taxation.

Although the history of the relationship of democratic thinking to the institution of inheritance is still to be written, one may surmise that much of the popular support for death taxes in our country has stemmed from the "democratic dogma," no doubt with a strong tinge of puritanical disapproval of idleness. The burgeoning of state inheritance taxes in the eighties and nineties of the last century must have been an offshoot of agrarian and labor unrest, and, though the present federal estate tax was adopted in 1916 under the pressure of war, its roots and later history are both bound up with the democratic dream of equal opportunity for all. Even before the freedom to *amass* a fortune was challenged by the income tax, there were doubts whether such a fortune should be *passed along* intact to those who had not earned it. American fiction has often glorified the poor boy who became the head of an enterprise by marrying the boss's daughter, but there is no record of similar enthusiasm for the boss's son who took his father's place by inheritance.

Theorists have developed a number of other defenses of inheritance taxation. It has been suggested, for example, that the death tax is an appropriate toll charged by the state for use of the probate machinery and for other services in facilitating the transfer of private property at death. Others have argued that the state is collecting a belated fee for protecting the property during the decedent's lifetime or, more cynically, that it is levying a kind of penalty for any tax evasion that the decedent may have indulged in during life. Still others assert that inheritance comes as a windfall; therefore the tax imposes no sacrifice on the heirs,

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4 Reprinted from North American Review for June, 1889, in Carnegie, The Gospel of Wealth (Doubleday Doran Co., Garden City, N. Y., 1933) 1, 9-11.

5 Principles of the Civil Code, Part II, c. III.

6 Principles of Political Economy, Book V, c. II, §3.

and they have an ability to pay that justifies the levy. One of the most influential of American authorities on public finance, E. R. A. Seligman, based his own support of the inheritance tax on arguments like these, rejecting the equalization of wealth theory as "very distinctly socialistic."[7] But it is hard to escape the conclusion that today's gift and estate taxes rest squarely on equalitarian foundations, to which these other theories are little more than decorative buttresses. Consequently one's attitude toward the tax is probably governed by the degree to which one wishes to see inequality of inheritance reduced. It is worth noting that for social and economic reasons some may favor equalization of *inherited* wealth without objecting to the same extent, if at all, to fortunes achieved by the personal effort of their owners.

Only an examination of the Treasury's files would disclose the extent to which estate and gift taxes have succeeded in their purpose of breaking up great family fortunes. Only since 1932 could important results have been achieved in this direction; before then, a net estate of $5 million, for example, would have been subjected to a federal tax of only about $500,000.[8] Between 1932 and 1950, as a result of several increases in rates, the tax on an estate of that size moved upward from a little more than $1 million to about $2 million.[9] The top tax bracket, reached by estates that exceed $10 million, has been 77 per cent since 1941. There have been examples since then of enormous estates that were really hard hit by death taxes. The $19.5 million estate of Robert W. Goelet was reduced to a net of less than $3 million by federal taxes of $11.5 million, state taxes of $4 million, and administration expenses of $1 million.[10] The estate of Mrs. Andrew Carnegie fared somewhat better, the federal and state tax bill being a little more than $11.5 million on an estate of $20.5 million of which $2.5 million was left to charity.[11] After the charitable legacies and taxes were paid, $6.5 million was left for the private beneficiaries.

In the case of the largest estates, the tax burden is often kept within manageable limits only by substantial bequests to non-profit family foundations or other institutions. The Edsel Ford estate paid nearly $25 million in federal estate taxes, but the figure would have been vastly larger if the Ford Foundation had not received all the decedent's nonvoting stock in the Ford Motor Company.[12] Henry Ford's estate, variously estimated at $70,000,000 to $500,000,000[13] would also have gone primarily to the federal government had it not been for his huge bequest to the Ford Foundation. Of course, since the tax rate does not reach 100 per cent, such charitable transfers do not come entirely out the Treasury's share of the estate. Even in the largest estates, nearly 25 per cent of the charitable contribution is taken from the decedent's other beneficiaries. But a charitable transfer may enable the individual heirs to retain control of the family fortune, either when nonvoting stock is transferred to the foundation or, if the foundation is in

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7 In 1943 the Soviet Union, which had reinstated the institution of inheritance after its initial abolition, repealed its heavy inheritance tax altogether. Gsovski, Soviet Law of Inheritance: I, 45 Mich. L. Rev. 291, 299 (1945). Among American states, only Nevada shares this distinction. Nev. Const., Art. X, §1.

8 The taxes paid in the early twenties by a group of large estates are reported in 37 Trust Companies 242 (1923); see Myers, The Ending of Hereditary American Fortunes (J. Messner, Inc., 1939) 276-290, 302-303, 327-332, 343, 356, 361.

9 State taxes (to the extent that they exceed the credit for state death taxes, see page 1325 infra) would impose an additional burden in most cases, but they would not ordinarily approach the federal tax in magnitude.

10 New York Times, August 18, 1950, page 7, col. 6.

11 Id., September 22, 1948, page 36, col. 6.

12 Id., September 28, 1947, page 24, col. 1.

13 Id., April 19, 1947, page 1, col. 4; October 29, 1948, page 22, col. 6.

friendly hands, even when voting stock is transferred to it.[14] On the other hand, if the entire estate had been left to the individual heirs, a sale to raise cash to meet the necessarily larger tax liability might have either created an unknown and potentially troublesome minority stockholding group[15] or terminated the family's control altogether. One need not deny the strength of the humanitarian impulse to suggest that charity is rewarded in these cases. Indeed, with stratospheric estates there may be no practicable alternative to becoming a benefactor of mankind.

The table below, compiled from Treasury reports, presents a composite view of the federal tax liabilities reported by certain large estates during 1959. It will be noted that the effective federal estate tax rate was 25 per cent on net estates of $1 to $2 million and 43 per cent on net estates of $5 million and over. Because the state tax liability is not reported, the total tax burden cannot be computed, but the credits taken for state death taxes under §2011 (supra note 9) disclose that these state taxes were not less than the amounts set out in lines 8 and 9 of the table.

TAXATION OF CERTAIN LARGE ESTATES[16]

(Returns filed in 1959)

In millions of dollars

	Gross Estates	
	$1-2 million	*$5 million and over*
1. Number of estates	759	84
2. Gross estate (aggregate)	$1038	$865
3. Charitable deductions (aggregate)	$ 60	$207
4. Other deductions (aggregate)	$ 265	$220
5. Net estate before exemption (aggregate)	$ 712	$438
6. Total federal estate tax (aggregate)	$ 189	$190
7. Effective federal estate tax rate (line 6 divided by line 5)	25%	43%
8. State death taxes	$25 or more	$40 or more
9. Effective state death tax rate (line 8 divided by line 5)	3.5% or more	9.1% or more

In estimating the extent to which moneyed dynasties are dying out under today's tax structure, it must be remembered that inter vivos gifts may escape the estate tax altogether. The federal gift tax rate is only three-quarters of the estate tax rate, so a sizeable fortune may be transferred at a comparatively modest tax

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14 The House version of the Revenue Act of 1950 would have denied the charitable deduction when the contributor or his family had control of the foundation to which shares of a family corporation were transferred. The provision was eliminated by the Senate. See Senate Finance Committee, S. Rept. No. 2375, 81st Cong., 2d Sess., pages 38-39.

15 In the case of the Ford Motor Company, a successful suit by a minority stockholder led to Henry Ford's purchase in 1919 of all minority interests. See Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919); Couzens v. Commissioner, supra page 919; Swards, The Legend of Henry Ford (1948) 64-74.

In 1956, the Ford Foundation sold part of its holdings in the Ford Motor Company, and these shares were given voting rights before the sale.

16 Compiled from Treasury Department, Statistics of Income. The information is taken from returns filed by citizens and resident aliens during the calendar year 1959, irrespective of date of death, and does not reflect corrections resulting from the Internal Revenue Service's audit of the returns. One other matter of importance is that the "net estate before exemption," upon which the tax rate is here computed, does not include several items of economic value to the heirs, e.g. tax-exempt life insurance. From the point of view of the heirs who receive such items, the effective tax rate is lower than the table indicates.

cost. A lifetime gift of $2.5 million, for example, would entail a gift tax liability of about $750,000 if made by a single person or about $635,000 if made by a married person. With large gifts, especially by persons of advanced age, there is always the possibility that the transfer will have to be treated as a gift "in contemplation of death," subject not merely to the lenient gift tax but to the estate tax as well. But the Revenue Act of 1950 mitigated this peril by restricting the "contemplation-of-death" clause of the estate tax law to transfers occurring within three years of the donor's death (§2035(b)). If this stimulates gifts by the rich, the effectiveness of the estate tax will be reduced pro tanto.

Moreover, in gauging the effectiveness of the estate and gift taxes it must be noted that they are no longer attuned primarily to the great hereditary fortunes that gave rise to the enactment of the federal estate tax in 1916. Much more modest transfers have been brought within their ambit by subsequent changes in the law. Congress has become more sensitive to economic inequality; an estate of $100,000 is considered a fair target for a certain amount of social leveling, although there is no clear and present danger that inheritances of this amount will create a class of industrial lords and aristocratic idlers.

If estate and gift taxes have not yet fulfilled all the hopes of their supporters, they have also fallen short of confirming the fears of their opponents. Enthusiasm for making money may be dampened by knowledge that the government will ultimately be an uninvited heir; on the other hand, there is the tantalizing possibility that the businessman now works harder to insure that his chosen heirs will receive a competence after taxes. Similarly, the possibility that business risks will be avoided and investment channeled into placid backwaters because of the tax may be countered by the possibility that greater risks will be undertaken because only thus can substantial sums be accumulated for the heirs. No conclusion as to the effects of estate and gift taxation on incentives can be more than a guess.

If we assume for the moment that the businessman's pursuit of gain is neither slackened because the prize no longer attracts him, nor spurred on by a desire to win a greater prize, what is the consequence of a death tax? Adam Smith formulated a classic view of the incidence of death taxes: "Taxes upon the transference of property from the dead to the living fall finally as well as immediately upon the person to whom the property is transferred." [17] Notwithstanding a certain looseness of language, which at times leads us to speak of a tax "on" the deceased, it is obvious that it is the living heirs, not the decedent, who bear the brunt of an inheritance or estate tax. And the heir — unlike the unionized wage earner whose income tax has been increased — can do little or nothing to shift the burden of the tax along to others in order to recoup the portion of his legacy to which the government has helped itself. He cannot ask a higher price for his own goods or services, because he is in competition with others who, not having suffered as he, are not impelled to raise their prices. He may work more diligently, but though this would increase the amount of work done in the world, thus fulfilling one of the announced aims of death taxation, it would not shift the "incidence" of the tax to others.[18]

What of the decedent: Could he during his life have shifted the tax by anticipation, so to speak? If the tax was established immediately before his death, and he did not foresee its enactment, he could have done nothing to prevent the tax

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[17] Wealth of Nations, Book V, c. 2, Part II, Appendix to Article I and II.

[18] This is not to say that the tax will have no effect on prices. By reducing the heir's demand for goods and services below the level which would have prevailed in the absence of a tax, it will tend to reduce the level of prices. The heir may be a beneficiary of this deflation, though of course it will be dispersed throughout the economy. It will also be counteracted to some extent if government spending increases because of the tax's yield.

from falling, as Smith said, "finally as well as immediately" upon his heirs. But if he anticipated the tax at an earlier date, he might have adjusted to it in various ways. One adjustment is not really an example of shifting but of avoidance: He might have made lifetime gifts, taking advantage of the gift tax's exemptions and lower rates. Or, as suggested earlier, he might have worked harder to build up an estate, after taxes, equal to what he would have aimed for had there been no tax.

Could he, however, without additional work, have passed the anticipated tax along by increasing the price at which he sold his goods or services? The classical economist would say that higher prices are feasible only when the marginal costs of producing identical goods or services have gone up. Since by definition the marginal producer is making no profit, presumably he is not troubled about a future estate tax. Hence he will not regard the tax as a cost of doing business and will neither raise his prices nor be forced out of business by his failure to do so. Therefore, runs this analysis, the fortune-builder whose behavior we are examining cannot raise *his* prices without losing his customers to the marginal firm. Critics of this theory have pointed out that even a tax that is not a direct cost of production will have an impact on the producer's profit expectations. If the tax leads him to decide that the reward no longer justifies the risk, he may reduce the scale of his operations or leave the industry altogether. Such action in turn would affect the supply of goods and thus influence prices. Although the estate tax may exert pressure on the level of prices in this way, however, the fortune-builder himself will not have succeeded in shifting the tax in the sense of recouping it from others.

More modern economists agree with the classical view that the estate tax cannot be recovered through higher prices, but their reasoning does not proceed along the line of marginal-cost analysis described above. They reject the theory that prices are inflexibly geared to the marginal cost of production because they recognize that price inequalities may persist in an economy characterized by monopolistic rather than "pure" competition. Nevertheless, each producer charges whatever price he believes will yield him the largest return, in the light of the competition he must face and of the monopolistic advantages (trade names, location, prestige, and so on) he enjoys. A revision in his expectations about the rate of estate taxes can hardly alter his view of the optimum price for his product, although conceivably it would overcome his inertia and impel him to make a change that would have been advisable previously. Even under modern economic analysis, then, Smith's conclusion as to the incidence of a death tax seems correct.

The traditional objection to the inheritance tax has been that it destroys productive capital by transferring wealth from private hands to the government. As expounded by Adam Smith, the theory rested on the assumption that taxes on the transfer of property "increase the revenue of the sovereign, which seldom maintains any but unproductive labours, at the expense of the capital of the people, which maintains none but productive." [19] In urging in 1924 that the federal estate tax rates be reduced, Secretary of the Treasury Andrew Mellon said:

> Death taxes are taxes upon capital. It is obvious that, if the government, to maintain itself, were to take 50 per cent of every estate, small or large, and if on the average in the course of a generation a man could not double his inheritance, there would be an actual depletion of capital within the country and ultimately nothing would be left to tax. This is clear enough. . . .[20]

Others have echoed the same theme.

[19] Supra note 17.

[20] Mellon, "Economic Aspects of Estate and Inheritance Taxation," 39 Trust Companies 708, 709 (1924).

The theory cannot be accepted without important qualifications. First, as already indicated, we do not know what adjustments the decedent made in the light of his expectations about the tax. Did he save more than he otherwise would have? If so, the transfer of part of his savings to the government does not reduce what would have been the aggregate of private savings in the absence of a tax. Second, one must compare the use to which the government puts the tax revenue with the use to which the heirs would have put the same funds. If they would have dined on guinea hen and champagne, the government's use of the tax revenue to build dams would serve to increase total national investment. If, on the other hand, they would have invested in new enterprises while the government increases the salary of its employees, total national investment is less for the tax.[21] Finally, if the estate finds it necessary to sell part of its assets (for example, shares of a family corporation) to pay the tax, the transfer will have an impact on total investment. This effect will depend upon the source from which the new owners of the securities draw the funds that make up the purchase price. If they curtail consumption to finance the purchase, the transfer of the securities will increase the investment of the new owners by as much as it decreases the investment of the estate, leaving total investment unchanged. If, on the other hand, the purchasers of the securities employ funds that otherwise would have gone into another investment, the tax has compelled the estate to reduce its investment without a corresponding increase in the investment of others. Then total private investment would tend to decline.

These three effects of the tax on total national investment (change in the original owner's savings, change in the government's expenditures, and change in the expenditures of those to whom the estate sells) need not be exerted in the same direction, and any conclusion about their net result would be precarious indeed. Consequently Secretary Mellon's simple prediction, which has enjoyed surprisingly wide acceptance, must be rejected.

Even if the estate tax could be shown, on balance, to discourage investment, it could not be condemned out of hand. For most contemporary economists recognize that the economy may be served better at one time by increasing total consumption and at another by increasing the volume of investment. And, as we have become painfully aware in recent years, there are times when expenditures for capital-destroying ends like armaments may serve the public (and even the heirs themselves) better than any other use of the funds.

It is sometimes asserted that a great fortune can no longer be accumulated, either because of high income tax rates or for other reasons, and that estate and gift taxation is therefore becoming an anachronistic survival of happier days. Although there is no statistical information, the premise is questionable. It is not likely, to be sure, that anyone could now accumulate a fortune that would be respectable by late nineteenth century standards if he had to rely upon salaries, dividends, or interest, since income of this nature may generate an effective income tax rate as high as 77 per cent (1964 rate). But the lower rate on long-term capital gains — and, in a more specialized field, the boon of percentage depletion — still hold out hope to the ambitious. It was reported in 1950 that a manufacturer of home permanent wave kits ("Which Twin Has the Toni?") had, at the age

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21 Of course, no government expenditure can be allocated to a specific tax collection, and even the total volume of expenditure is sometimes (for example, during a war) uninfluenced by the volume of revenue. Consequently it might be argued that the extent of investment by the government is independent of the estate tax yield. Then the effect of the tax on investment would depend upon (1) whether the decedent had accumulated more during his lifetime in anticipation of the tax, and (2) whether, when investments are sold by the estate to pay the tax, the buyers curtail consumption in order to raise the purchase price.

of 33, sold out a company in which he had invested $1000 four years earlier, for $20 million.[22] The tax on capital gains would take only 25 per cent of the profit. The Levitt family is said to have made more than $5 million on a single year's construction activities, of which at least a portion was capital gain rather than ordinary income.[23] A happy combination of capital gains and percentage depletion is reported to have created a new crop of millionaires in the previously unassuming state of Texas.[24] Moreover, unrealized appreciation in property is not reached by the income tax, and a 1963 proposal by President Kennedy to alter this aspect of existing law was rejected by Congress.[25] Thus, stock or real estate will generate no income tax liability at all if held until death. A wise, or even a fortuitous, investment may be the seed that grows into a great fortune without any diminution by the Internal Revenue Service. Although one cannot know how many persons have become millionaires in recent years, it seems likely that, as long as the income tax laws continue to leave the door open to substantial accumulations, the estate and gift taxes will have a task to perform.

The federal government imposes an *estate* tax, while most of the states impose *inheritance* taxes. The traditional differentiation between them is that an estate tax is levied on the privilege of transmitting property at death, while an inheritance tax is on the privilege of receiving property from the dead. Terminology aside, the distinction is between a tax graduated according to the size of the decedent's entire estate and one that is graduated for each beneficiary according to the size of his share and his relationship to the decedent.

Theoretically an estate tax is simpler to administer than an inheritance tax, because it is not necessary to place a value on each beneficiary's portion, a task of some complexity when future interests are involved. Yet the federal estate tax does not escape this problem altogether. A deduction has always been allowed for charitable bequests, and in 1948 a "marital deduction" was inaugurated for property passing to a surviving spouse. Both deductions introduce inheritance tax characteristics into the estate tax structure. Moreover, it is becoming ever more common to provide (either by will or by statute) that the federal tax shall be apportioned among the various property interests that constitute the estate, instead of falling, as do other debts and charges, on the residuary alone. Although such an apportionment is not binding on the Treasury, which can collect the tax from any part of the estate, the executor must value each beneficiary's share in order to apportion the tax in accordance with the testamentary or statutory scheme.

Since the inheritance tax is graduated according to the heir's relationship to the decedent, it could be employed to penalize close family control of the decedent's fortune. This is a function that the estate tax, ordinarily taking no account of the beneficiary's identity, could not perform. In point of fact, however, the inheritance tax rate schedules place a premium on transfers to direct descendants, the purpose of breaking up family accumulations being overbalanced in this instance by an ethical view that direct descendants have a birthright claim to the wealth while legacies to collateral relatives and "strangers" are in the nature of windfalls. (The federal "marital deduction," mentioned in the preceding paragraph, makes a similar concession in the case of property passing to the decedent's widow or widower.) Thus, in Massachusetts, the tax on "Class A beneficiaries" (spouses, parents, children, and grandchildren) ranges from 1 per cent on the first

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[22] Life, April 4, 1949, page 72, 84.
[23] Time, July 3, 1950, page 72.
[24] "The Land of the Big Rich," Fortune, April, 1948, page 98.
[25] Supra page 486.

$10,000 received to 9 per cent on the excess over $1 million. The rates on "Class B beneficiaries" (lineal ancestors other than parents, lineal descendants other than children and grandchildren, daughters-in-law, and sons-in-law) range from 2 per cent to 11 per cent; on "Class C beneficiaries" (brothers and sisters, nephews and nieces, step-children, and step-parents), from 4 per cent to 15 per cent; on "Class D beneficiaries" (all others), from 6 per cent to 15 per cent. The classifications and rates vary among the 40 states that impose inheritance taxes, but the broad outline is the same: close rather than distant beneficiaries are favored by the inheritance tax rates. Indeed, in the first state inheritance tax (1826), Pennsylvania exempted direct heirs altogether, setting a pattern that was not broken until the last decade of the nineteenth century.

In another respect, however, a graduated inheritance tax encourages the dispersion of wealth more than the estate tax. Being graduated separately for each beneficiary's share, such an inheritance tax penalizes less heavily the fortune that is divided among two or more beneficiaries (of a given statutory class) than one that goes to a single member of that class. To take Massachusetts as an example again, if an estate of $300,000 were left to one child, the tax would be $13,650, while if the same estate were divided among three children, the tax on each share would be $3,150, and the total tax $9,450. Although a tax difference of this size is hardly an incentive to dispersion, the inheritance tax contains a seed that might be nurtured into effective life. The estate tax, on the other hand, does not discriminate among recipients of the decedent's bounty (except for the charitable and marital deductions) and, since the rate fluctuates only with the size of the *entire* estate, it does not place a heavier burden on an estate that is transferred to a single beneficiary than on one that is split up among a number.

Neither an estate nor an inheritance tax could be very effective if it reached only property owned by the decedent on the date of his death. Indeed, the larger the fortune, the more feasible it would ordinarily be to avoid a death tax by inter vivos gifts. The problem was recognized and met in Pennsylvania's 1826 statute, mentioned earlier, which reached out to bring into the taxable estate any property whose transfer was "intended to take effect, in possession or enjoyment after the death" of the transferor. It has since become standard operating procedure to include such a provision in death tax statutes; its exegesis is the subject of extended study in this book. In 1891, the New York inheritance tax law introduced another now famous clause, which subjected to the death tax any property that the decedent had transferred during his lifetime "in contemplation of death." These clauses, and other provisions with a similar aim, have extended the web of both the estate and the inheritance tax to catch much peripheral property, which is added to that which the decedent owned outright at the time of death in computing the tax.

Property may still be transferred during one's life, and thereby escape death tax, if the transferor retains no strings and is not acting "in contemplation of death." Estate and inheritance taxes are to that extent ineffectual as revenue measures and, more important, as instruments for reducing inequality of wealth. Indeed, one commentator has observed:

> Until recently, the whole system of levies in the United States could be regarded mainly as a penalty on those whose benefactors failed to pass down their property before death. That any revenues were forthcoming is presumably attributable to untimely deaths, to utter distrust of beneficiaries, or to mere disregard of their interests.[26]

To block this route by which assets may be transmitted from one generation to another without payment of estate or inheritance tax, the federal government

[26] Simons, Personal Income Taxation (University of Chicago Press, Chicago, Ill., 1938) 131.

and 12 states have enacted a gift tax. As will be seen more fully later, an inter vivos transfer may still be cheaper than a transfer at death, because of the gift tax's lower rates, generous exemptions, and separate scale of progression, although there are also counterbalancing tax advantages in postponing the transfer of one's property until death. If a transfer during life is subjected to a federal gift tax and ultimately is determined to be subject to the federal estate tax as well (because, for example, it was made "in contemplation of death"), the estate may be permitted to credit the gift tax as a "down payment" on the estate tax liability.[27] Needless to say, the line separating transfers subject only to gift tax from those that engender estate tax liability as well is often established only by litigation.

The difficulty of drawing this line of demarcation and, even more, grave doubt whether it should exist at all have led to proposals for merging the two existing levies into an "integrated transfer tax." [28] Such a tax would impose — as today's federal gift and estate taxes do not — about the same total tax burden on an estate transferred piecemeal over the years as on one that is held intact until death. The existing dual structure may foster an earlier division of wealth, presumably a socially desirable trend, but the extent to which it does so is problematical. The volume of gifts reported to the Treasury is surprisingly meager.[29] An integrated transfer tax would have advantages that might outweigh any favorable aspects of the present discrimination in favor of lifetime gifts.

Integration has another aspect: What is (or should be) the relationship between gift and death taxes, on the one hand, and the income tax, on the other? As the law now stands, a transfer of property from father to son may be complete enough so that a gift tax must be paid by the father, yet the yield from the transferred property may still be taxed as his income. Contrariwise, a transfer may be insufficiently final to require payment of gift tax, yet complete enough to terminate the father's income tax liability. Similarly, a transfer may shift the income tax liability although the property will be subject to the estate tax as part of the transferor's estate, and vice versa. Judge Jerome N. Frank has suggested that the concept of a transfer is so different from one taxing statute to another that different verbal symbols might be used "to describe the taxable conduct in the several statutes, calling it a 'gift' in the gift tax law, a 'gaft' in the income tax law, and a 'geft' in the estate tax law." [30] The statutory anomalies spring from minor differences in phraseology rather than from rational policy, and one proposal for integrating the estate and gift taxes provides for "correlating" the substituted transfer tax with the income tax.[31] The aim is to tax the income from the property to its original owner until he relinquishes enough control to warrant payment of the transfer tax, but to relieve him of income tax liablity thereafter.

Another anomaly in the relation between the gift and estate taxes and the income tax is the transferee's "basis" for property received by gift or inheritance. Suppose the value of stock purchased by the original owner for $100 per share

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[27] The credit sometimes equals only a part of the gift tax paid, rather than its full amount. Infra page 1330.

[28] See footnote 31 infra.

[29] See Pechman, Analysis of Matched Estate and Gift Tax Returns, 3 Nat. Tax J. 153 (1950); Butters, Thompson, and Bollinger, Effects of Taxation: Investments by Individuals, c. XV (1953).

[30] Commissioner v. Estate of Beck, 129 F.2d 243, 246 (2d Cir. 1942).

[31] Federal Estate and Gift Taxes: A Proposal for Integration and for Correlation with the Income Tax (1947), prepared jointly by an Advisory Committee to the Treasury Department and by the Office of Tax Legislative Counsel, discussed in Platt, Integration and Correlation — The Treasury Proposal, 3 Tax L. Rev. 59 (1947), and Wales, Consistency in Taxes — The Rationale of Integration and Correlation, id. 173.

For other proposals, see Groves and Edwards, A New Model for an Integrated Transfer Tax, 6 Nat. Tax J. 353 (1953); Vickrey, An Integrated Successions Tax, 22 Taxes 368 (1944).

has appreciated to $200 at the time the shares are transferred by gift or inheritance. If the recipient later sells the stock for $250 per share, will his gain be $50 or $150? If the transfer was by gift, §1015(a) of the Internal Revenue Code requires the donee to use his donor's cost "basis" of $100, so that the gain on the sale is $150 per share. But if the stock was received by inheritance, the beneficiary's "basis," prescribed by §1014(a) of the Internal Revenue Code, is the fair market value at the time of his transferor's death, or $200, so that the gain on the sale is only $50 per share. Thus appreciation in donated property will be charged against the donee, but appreciation in property held until death goes entirely untaxed.[32] The discrimination works against the tax advantages, mentioned above, that inter vivos gifts ordinarily enjoy over transfers at death. Moreover, the "stepped-up" basis that attaches to appreciated property transmitted at death undoubtedly reduces the liquidity of such assets when held by persons of advanced age.

More basic in the relationship between the transfer taxes and the income tax is the fact that property received by gift or inheritance is not treated as income to the transferee upon receipt. The exemption of gratuitous receipts (assuming it is not compelled by the Constitution)[33] has been defended on various grounds, principally because the transfer itself is subject to gift or inheritance tax, but also because the progressive nature of the income tax would levy a heavy toll on any property that was transferred in a single year rather than over a period of time. Neither objection inheres in the nature of things. The gift and estate taxes could be modified or abolished if it were better tax policy to treat gratuitous receipts as taxable income; and an "averaging" device could be employed to remedy the unfair "bunching" of income in a single year.[34] But abolition of the existing exemptions has never been seriously considered by Congress, despite vigorous advocacy of such action by at least one distinguished tax economist, the late Henry Simons.[35]

Somewhat more interest has been displayed in another proposal relating to gratuitous receipts, although it too is still far from Congressional action. This is the "accessions" tax, a scheme to replace the existing estate and gift taxes by a single tax imposed on the recipient of property by gift or inheritance.[36] The tax would be cumulative throughout the recipient's life, taxing each "accession" to his unearned wealth more heavily than the previous increment. No distinction would be made between gifts and inheritance or between property received from one benefactor and property received from several. The novel feature of the proposed tax is that it would focus attention on the recipient of wealth rather than on the transferor, treating all gratuitously acquired wealth as a unit. Thus, a taxpayer who received a total of $1 million partly by gift and partly by inheritance from various benefactors over a period of time would incur the same tax liability as one who received the same amount at one time from a single transferor. The accessions tax might be likened to an income tax levied only on gratuitous receipts, but with the lowest tax bracket each year starting where the highest

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32 For President Kennedy's 1963 legislative proposals in this area, see page 486 supra.

33 Since these receipts have enjoyed a statutory exemption since the prototype of today's federal individual income tax was enacted in 1913, there has been no occasion for a judicial determination whether they constitute income within the meaning of the Sixteenth Amendment. But they were treated as income by the Revenue Act of 1894, the invalidation of which by Pollock v. Farmers' Loan & Trust Co., supra, page 5, led to the adoption of the Sixteenth Amendment.

34 Supra, pages 827-831.

35 Simons, Personal Income Taxation (1938) 125-147; see also his Federal Tax Reform (1950) 136-139; cf. Vickrey, Agenda for Progressive Taxation (1947) 198-202.

36 Rudick, A Proposal for an Accessions Tax, 1 Tax L. Rev. 25 (1945); Rudick, What Alternative to the Estate and Gift Taxes? 38 Calif. L. Rev. 150 (1950).

bracket of the previous year ended. The "accessions" tax is an effort to achieve more completely the social aim of the gift and death taxes, not only by taxing more heavily a fortune that is transmitted intact than one that is split up, but also by taxing more heavily the transferee who already has received property from other transferors. The estate tax does neither, while the gift and inheritance taxes do only the first.

Other proposals for reforming the structure of transfer taxation are aimed at the fact that under existing law, the size of the tax on the transmission of a family fortune depends upon the number of transfers that occur, rather than on the number of generations separating the transferor from the transferee. Thus, if *A* gives property to *B*, his son, and *B* (after enjoying the income for a time) gives the same property to *C*, his son, two gift taxes must be paid. Only one would be due if the property were transferred directly by *A* to *C*. Similarly, if there were two transfers by will, both *A*'s estate and *B*'s would be subjected to estate tax;[37] but only one estate tax would be due if *A*'s will had granted a life interest to *B* and the remainder upon *B*'s death to *C*. And if *A* had been so unwise as to leave the property to his wife, who later transferred it to *B*, there would be still another tax (and yet another if *B* in turn had transmitted it to *his* wife), though some alleviation for interspousal transfers is afforded by the "marital deduction" introduced by the Revenue Act of 1948. That deduction aside, the total tax burden on a given family fortune is governed by the number of hands — rather than the number of generations — through which the property passes. In some cases the number of transfers is determined by accidents of birth and longevity, resulting in unequal tax burdens upon taxpayers whose economic circumstances may be comparable. In others, the number of transfers and therefore the total tax burden are determined by ingenuity in the use of life estates and other devices that may introduce undesirable rigidities into family settlements and that in any event are more feasible for the really rich than for others.

Several schemes have been devised to insure that the same burden will be imposed on the transfer of a given sum from one generation to another regardless of the number of steps in which this is accomplished. One of the most ingenious, although its complexity is forbidding, is the "bequeathing power succession tax" proposed by Professor William Vickrey.[38] His mechanism for making the tax independent of the number of transfers is to graduate it according to the difference in age between the transferor and transferee, so that the greater the gap the greater will be the tax. Two other remedies for the same evil, which depart much less radically from the present tax structure, are (1) to levy the existing estate tax on the life beneficiary (*B* in the example above) at the time of his death by including the property of which he is the life tenant in his estate, or (2) to levy a new auxiliary tax on the life tenant, based solely upon property of which he has enjoyed the income.[39]

This catalogue of possible reforms should not be closed without mention of the Rignano plan for increasing the rate of the inheritance tax with the number of transfers intervening between the present owner and the original creator of the wealth.[40] Thus *Z*'s property on his death would be segregated according to its

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37 If, however, B's death occurred within ten years of A's, B's estate would be entitled to take a credit for part or all of the tax paid by A's estate, under the previously taxed property provision, §2013. See page 1330 infra.

38 Vickrey, Agenda for Progressive Taxation (1947) 224-248.

39 See Surrey, An Introduction to Revision of the Federal Estate and Gift Taxes, 38 Calif. L. Rev. 1, 18-23 (1950); Mills, Transfers from Life Tenant to Remainderman in Relation to the Federal Estate Tax, 19 Taxes 195 (1941); infra pages 1103-1105.

40 Rignano, The Social Significance of the Inheritance Tax (1924).

origin and taxed accordingly: one tax rate on that part which Z had himself earned or saved: another and higher rate on that part inherited from X which X had himself earned or saved; a still higher rate on that part inherited from X which X in turn had inherited from its creator Y; and so on. By imposing a confiscatory rate after several transfers, Rignano's plan would permit a family fortune to continue only if each generation or two through its own efforts made substantial additions to the accumulation.

No doubt the reader has found this kaleidoscope of proposed reforms bewildering. Encountering them without a familiarity with the existing law, he may also have found the significance of some proposals a bit obscure. But even a casual acquaintance with possible improvements may help to illuminate his study of today's statutes; and alternatives should not be regarded as mere afterthoughts, but instead should be evaluated at many points in the study of what follows.

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Incidence and Effects. There is a brief summary of the arguments on the incidence and effects of death taxes in Groves, Postwar Taxation and Economic Progress (1946) 243-250. See also Committee on Postwar Tax Policy, A Tax Program for a Solvent America (1945) 155-169; Wedgewood, The Economics of Inheritance (Pelican ed., 1939) 225-239; Dalton, Public Finance (3d ed., 1936) 114-118; Pigou, A Study in Public Finance (3d ed., 1949) 138-146; von Mering, The Shifting and Incidence of Taxation (1942) 216-223; Hicks, Public Finance (1947) 231-248; Stamp, The Fundamental Principles of Taxation (1936) 143-153; Phillips, Social Control Through Taxation of Estates and Trusts, 23 Cornell L. Q. 113 (1937); Woolfson, Inheritance Taxation and Maladjustment of National Income, 15 Taxes 458 (1937); Harriss, Sources of Injustice in Death Taxation, 7 Nat. Tax J. 289 (1954); Looker, The Impact of Estate and Gift Taxes on Property Disposition, 38

Calif. L. Rev. 44 (1950); Harriss, Economic Effects of Estate and Gift Taxation, in Federal Tax Policy for Economic Growth and Stability (Joint Committee on the Economic Report, 84th Cong., 1st Sess., 1955) page 855; Bosland, Has Estate Taxation Induced Recent Mergers? 16 Nat. Tax J. 159 (1963).

Legal. Although legal articles and treatises are cited at appropriate points in the text, a few should receive special mention here. For a comprehensive account of federal estate and gift taxation, see Lowndes and Kramer, Federal Estate and Gift Taxes (2d ed., 1962), and Paul, Federal Estate and Gift Taxation (1942, with 1946 Supplement), which is outdated at points but still useful. Briefer studies are Lewis, The Estate Tax (1960), and Craven, The Gift Tax (1963), both published by the Practising Law Institute in the series, Fundamentals of Federal Taxation, and revised periodically. An incisive account of the judicial history of the federal estate tax is Eisenstein's, Estate Taxes and the Higher Learning of the Supreme Court, 3 Tax L. Rev. 395 (1948). See also American Law Institute, Federal Income, Estate and Gift Tax Statute (Tentative Draft No. 11, 1956); Symposium, A Critique of Federal Estate and Gift Taxation, 38 Calif. L. Rev. 1 (1950).

On estate planning, see Casner, Estate Planning (3d ed. 1961, with supplement); Trachtman, Estate Planning (Practising Law Institute, 1964); Estate Planning, 1963 U. of Ill. L.F. 123.

CHAPTER 11

Federal Gift Taxation: Introductory

The materials in this chapter are no more than an introduction to the federal gift tax, sketching as they do only an outline of the tax's coverage. The details have been postponed until later chapters in order to compare the competing claims of the gift tax and the estate tax in specific situations.

SECTION A. CONSTITUTIONALITY

BROMLEY v. McCAUGHN

280 U.S. 124 (1929)

MR. JUSTICE STONE delivered the opinion of the Court. . . .

Bromley, a resident of the United States, brought the present suit in the District Court for Eastern Pennsylvania, to recover a tax alleged to have been illegally exacted, upon gifts made by him after the effective date of §319 of the Revenue Act of 1924. This section imposes a graduated tax "upon the transfer by a resident by gift" during the calendar year "of any property wherever situated. . . ." In computing the amount of the gift subject to the tax, §321, in the case of a resident, exempts gifts aggregating $50,000, gifts to any one person which do not exceed $500, and certain gifts for religious, charitable, educational, scientific and like purposes. The questions certified [by the Court of Appeals for the Third Circuit] are:

1. Are the provisions of Sections 319-324 of the Revenue Act of 1924, as amended by Section 324 of the Revenue Act of 1926, when applied to transfers of property by gift inter vivos, made after the effective dates of the cited Revenue Acts and not made in contemplation of death, invalid, because they violate (a) the third clause of Section 2 and (b) the fourth clause of Section 9 of Article 1 of the Constitution in that the tax they impose is a direct tax and has not been apportioned?

2. Are the cited provisions, when applied to transfers of property made in like circumstances, invalid because they violate (a) the Fifth Amendment of the Constitution and (b) the first clause of Section 8 of Article 1 of the Constitution in that they impose a tax which is graduated and subject to exemptions and therefore lacks uniformity, and also deprive a person of his property without due process of law?

1. The first question was mooted by counsel, but not decided, in Blodgett v. Holden, 275 U.S. 142, and Untermeyer v. Anderson, 276 U.S. 440. The general power to "lay and collect taxes, duties, imposts and excises" conferred by Article I, §8 of the Constitution, and required by that section to be uniform throughout the United States, is limited by §2 of the same article, which requires "direct" taxes to be apportioned, and §9, which provides that "no capitation or other direct tax shall be laid unless in proportion to the census" directed by the Constitution to be taken. As the present tax is not apportioned, it is forbidden if direct.

The meaning of the phrase "direct taxes" and the historical background of the

Constitutional requirement for their apportionment have been so often and exhaustively considered by this Court . . . that no useful purpose would be served by renewing the discussion here.* Whatever may be the precise line which sets off direct taxes from others, we need not now determine. While taxes levied upon or collected from persons because of their general ownership of property may be taken to be direct, Pollock v. Farmers Loan & Trust Company, 157 U.S. 429, 158 U.S. 601, this Court has consistently held, almost from the foundation of the government, that a tax imposed upon a particular use of property or the exercise of a single power over property incidental to ownership, is an excise which need not be apportioned, and it is enough for present purposes that this tax is of the latter class. . . .

It is a tax laid only upon the exercise of a single one of those powers incident to ownership, the power to give the property owned to another. Under this statute all the other rights and powers which collectively constitute property or ownership may be fully enjoyed free of the tax. So far as the constitional power to tax is concerned, it would be difficult to state any intelligible distinction, founded either in reason or upon practical considerations of weight, between a tax upon the exercise of the power to give property inter vivos and the disposition of it by legacy, upheld in Knowlton v. Moore [178 U.S. 41], the succession tax in Scholey v. Rew, 23 Wall. 331, the tax upon the manufacture and sale of colored oleomargarine in McCray v. United States, 195 U.S. 27, the tax upon sales of grain upon an exchange in Nicol v. Ames [173 U.S. 509], the tax upon sales of shares of stock in Thomas v. United States, 192 U.S. 363, the tax upon the foreign built yachts in Billings v. United States, 232 U.S. 261, the tax upon the use of carriages in Hylton v. United States [3 Dall. 171]; compare Veazie Bank v. Fenno, 8 Wall. 533, 545, Thomas v. United States, supra, 370.

It is true that in each of these cases the tax was imposed upon the exercise of one of the numerous rights of property, but each is clearly distinguishable from a tax which falls upon the owner merely because he is owner, regardless of the use or disposition made of his property. See Billings v. United States, supra; cf. Pierce v. United States, 232 U.S. 290. The persistence of this distinction and the justification for it rest upon the historic fact that taxes of this type were not understood to be direct taxes when the Constitution was adopted and, as well, upon the reluctance of this Court to enlarge by construction, limitations upon the sovereign power of taxation by Art. I, §8, so vital to the maintenance of the National Government. Nicol v. Ames, supra, 514, 515.

It is said that since property is the sum of all the rights and powers incident to ownership, if an unapportioned tax on the exercise of any of them is upheld, the distinction between direct and other classes of taxes may be wiped out, since the property itself may likewise be taxed by resort to the expedient of levying numerous taxes upon its uses; that one of the uses of property is to keep it, and that a tax upon the possession or keeping of property is no different from a tax on the property itself. Even if we assume that a tax levied upon all the uses to which property may be put, or upon the exercise of a single power indispensable to the enjoyment of all others over it, would be in effect a tax upon the property, see Dawson v. Kentucky Distilleries & Warehouse Co., 255 U.S. 288, and hence a direct tax requiring apportionment, that is not the case before us.

The power to give cannot be said to be a more important incident of property than the power to use, the exercise of which was taxed in Billings v. United States, and even though differences in degree may be carried to a point where they produce distinctions in kind, the present levy falls so far short of taxing generally the

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* Supra pages 5-7. — Ed.

uses of property that it cannot be likened to the taxes on property itself which have been recognized as direct. It falls, rather, into that category of imposts or excises which, since they apply only to a limited exercise of property rights, have been deemed to be indirect and so valid although not apportioned.

2. The uniformity of taxation throughout the United States enjoined by Art. I, §8, is geographic, not intrinsic. A graduated tax on legacies, granting exemptions, Knowlton v. Moore, supra, or on incomes, Brushaber v. Union Pacific R. Co., 240 U.S. 1, does not violate this clause of the Constitution, nor are such taxes infringements on the Fifth Amendment. Knowlton v. Moore, supra, page 109; Brushaber v. Union Pac. R. Co., supra, pages 24, 25. Graduated taxes on inheritances or successions, with provisions for exemptions, have so often been upheld as not violating either the due process or the equal protection clauses of the Fourteenth Amendment, Stebbins v. Riley, 268 U.S. 137, as to leave little ground for supposing that taxation by Congress embracing these features, and otherwise valid, could be deemed a denial of the due process clause of the Fifth. See Van Oster v. Kansas, 272 U.S. 465, 468.

It is suggested that the schemes of graduation and exemption in the present statute, by which the tax levied upon donors of the same total amounts may be affected by the size of the gifts to individual donees, are so arbitrary and unreasonable as to deprive the taxpayer of property without due process. But similar features of state death taxes have been held not to infringe the Fourteenth Amendment since they bear such a relation to the subject of the tax as not "to preclude the assumption that the legislature, in enacting the statute, did not act arbitrarily or without the exercise of judgment and discretion which rightfully belong to it." Stebbins v. Riley, supra, p. 145. No more can they be a basis for holding that the graduation and exemption features of the present statute violate the Fifth Amendment.

The answer to both questions is, No.

Opinion of MR. JUSTICE SUTHERLAND, dissenting, delivered by MR. JUSTICE BUTLER.

In the convention which framed the Constitution, Mr. King on one occasion asked what was the precise meaning of "direct taxation," and Mr. Madison informs us that no one answered. That Mr. Madison took the pains to record the incident indicates that it challenged attention but that no one was able to formulate a definition. And though we understand generally what is a direct tax and what taxes have been declared to be direct, we are still as incapable of formulating an exact definition as were those who wrote the taxation clauses into the Constitution. Since the *Pollock* case, however, we know that a tax on property, whether real or personal, or upon the income derived therefrom, is direct; and that to levy a tax by reason of ownership of property is to tax the property. Dawson v. Kentucky Distilleries Co., 255 U.S. 288, 294.

The right to give away one's property is as fundamental as the right to sell it or, indeed, to possess it. To give away property is not to exercise a separate element or incident of ownership, like the use of a carriage, but completely to sever the donor's relation to the property and leave in him no element or incident of ownership whatsoever. Reasonably it cannot be doubted that the power to dispose of property according to the will of the owner is a property right. If a tax upon the sale of property, irrespective of special circumstances, is a direct tax, it is clear that a tax upon the gift of property, irrespective of special circumstances, is, likewise, direct. In my opinion, both are direct because they are in substance and effect not excise taxes but taxes upon property. By repeated decisions of this Court it has become axiomatic that it is the substance and not the form that controls in such matters. . . .

To me it seems plain that a tax imposed upon an ordinary gift, to be measured by the value of the property given and without regard to any qualifying circumstances, is a tax by indirection upon the property, as much for example, as a tax upon the mere possession by the owner of a farm, measured by the value of the land possessed, would be a tax on the land. To call either of them an excise is to sacrifice substance to a mere form of words. I think, therefore, the first question certified, without stopping to consider the second, should be answered in the affirmative.

MR. JUSTICE VAN DEVANTER and MR. JUSTICE BUTLER concur in this opinion.

NOTE

1. *Retroactivity.* The gifts in Bromley v. McCaughn were made after enactment of the Revenue Act of 1924. In Blodgett v. Holden, 275 U.S. 142 (1927), the Court was concerned with gifts made in the early part of 1924, before the Revenue Act of 1924 was under Congressional consideration; four justices interpreted the statute to apply to the gifts and expressed the view that its retroactive application violated the Fifth Amendment, while four others construed the statute as not intended to reach the gifts in dispute. In Untermyer v. Anderson, 276 U.S. 440 (1928), involving a gift made while the bill that became the Revenue Act of 1924 was in conference, a majority of the Court accepted the view expressed in Blodgett v. Holden by the four justices who found that Congress intended to tax the gift and that as applied the statute was unconstitutional. Three justices dissented, citing cases in which the federal income tax was held to be constitutionally valid as applied to income earned during the early part of the year of enactment. For more on retroactivity, see Sidney v. Commissioner, 273 F.2d 928 (2d Cir. 1960).

2. *History.* The gift tax provisions of the Revenue Act of 1924 were repealed as of January 1, 1926. A gift tax was reimposed in 1932, however, but with an important new feature distinguishing it from its predecessor: the 1932 tax, which is still in force, is cumulative in the sense that the tax on gifts made in the current year is graduated by reference to the aggregate of the donor's gifts in prior years. An echo of the retroactivity problem discussed in the preceding paragraph is to be found in §2502(b), under which a gift is taken into account only if made after June 6, 1932, when the Revenue Act of 1932 was enacted.

The 1932 tax took account of a transfer only to the extent that the donor's gifts to the donee in question exceeded $5000 in the calendar year; thus, if a donor transferred $7000 to each of 3 donees in a given calendar year, he was entitled to a $5000 exclusion for each donee, so that his "gifts" for tax purposes amounted to only $2000 per donee, or a total of $6000. The per-donee exclusion is available anew every year, and there is no limit on the number of qualifying donees. The amount of the exclusion (which is not allowed if the gift consists of a future interest in property) was reduced to $4000 for the years 1939-1942 and to $3000 for subsequent years.

In addition to the $3000 annual per-donee exclusion, the donor is allowed a lifetime exemption of $30,000 by §2521; thus, if a taxpayer gives $8000 per year to each of 5 donees in 1964, 1965, and 1966, the "total amount of gifts" under §2503(b) is $25,000 for each year; and if he has not previously used any of his lifetime exemption of $30,000 and elects to use it in 1964-1965, his "taxable gifts" under §2503(a) are zero in 1964, $20,000 in 1965, and $25,000 in 1966. In the case of a married couple, the $3000 per-donee exclusion and the $30,000 lifetime exemption are in effect doubled if they elect to employ the "split gift" privilege of §2513(a). For more on the computation of the tax, see page 1070 infra.

3. *Types of property subject to tax.* Section 2501(a) provides that the gift tax applies to transfers of "property," and §2511(a) states that it does not matter whether "the property is real or personal, tangible or intangible." This language embraces so-called "tax-exempt" state and municipal bonds, Regs. §25.2511-1(a), and the tax, being an excise on their transfer, is not unconstitutional, Willcuts v. Bunn, 282 U.S. 216, 230 (1931). In Phipps v. Commissioner, 91 F.2d 627 (10th Cir. 1937), cert. denied, 302 U.S. 742 (1937), moreover, it was held that a transfer of federal bonds issued under a statute providing

that they were "exempt, both as to principal and interest, from all [federal, state, or local] taxation, except estate or inheritance taxes" was subject to gift tax.

The tax is less sweeping, however, if the donor is a nonresident alien (including certain citizens who are residents of a U.S. possession and meet the test of §2501(c)). For such persons, a gift is taxable only if the property "is situated within the United States," and, in the case of corporate stock, only if the issuer is a domestic corporation. §2511(a) and (b). (Regulations §25.2511-3(b)(2) interprets §2511(b) to mean that domestic stock has a U.S. situs regardless of the physical location of the certificates.) If the nonresident alien donor is not engaged in business within the United States, moreover, §2501(a) exempts transfers of all intangible property.

The territorial reach of the federal gift tax is also affected by bilateral tax conventions with Australia and Japan.

4. *Tax imposed on "individuals."* Section 2501(a) imposes the gift tax on the gift of property "by any individual." What of gifts by a corporation? The Regulations state that a transfer of property by a corporation is a gift pro tanto by the stockholders, §25.2511-1(g)(1), which accords with the views of the committees of Congress that recommended the enactment of the present gift tax. H.R. Rept. No. 708 and S. Rept. No. 665, 72d Cong., 1st Sess., reprinted, 1939-1 C.B. (Part 2) 476, 524. What if a stockholder objects to the gift?

As to transfers by trustees, see Regs. §25.2511-1(g).

5. *Relation of gift tax to estate tax.* As will be seen, property transferred during the donor's lifetime is sometimes includible in his gross estate in computing the federal estate tax on his death, even though the transfer was subject to a gift tax when made; a common example of this overlap between the two taxes is a gift in contemplation of death (infra p. 1136). In such cases, the gift tax is ordinarily credited against the estate's federal estate tax liability as though it were a "down payment," but the credit (infra p. 1330) is not necessarily equal to the full amount of gift tax paid.

6. *Relation of gift tax to income tax.* For the donee's "basis" in computing his gain or loss for income tax purposes on a sale or other disposition of property received by gift, including an adjustment in some instances to reflect the gift tax paid on the transfer, see page 102 supra.

7. *Reference.* Harriss, Legislative History of Federal Gift Taxation, 18 Taxes 531 (1940).

Section B. Revocable and Other Incomplete Transfers

BURNET v. GUGGENHEIM

288 U.S. 280 (1933)

Mr. Justice Cardozo delivered the opinion of the Court.

The question to be decided is whether deeds of trust made in 1917, with a reservation to the grantor of a power of revocation, became taxable as gifts under the Revenue Act of 1924 when in 1925 there was a change of the deeds by the cancellation of the power.

On June 28, 1917, the respondent, a resident of New York, executed in New Jersey two deeds of trust, one for the benefit of his son, and one for the benefit of his daughter. The trusts were to continue for ten years, during which period part of the income was to be paid to the beneficiary and part accumulated. At the end of the ten year period the principal and the accumulated income were to go to the beneficiary, if living; if not living, then to his or her children; and if no children survived, then to the settlor in the case of the son's trust, and in the case of the daughter's trust to the trustees of the son's trust as an increment to the fund. The settlor reserved to himself broad powers of control in respect of the trust property and its investment and administration. In particular, there

was an unrestricted power to modify, alter or revoke the trusts except as to income, received or accrued. The power of investment and administration was transferred by the settlor from himself to others in May, 1921. The power to modify, alter or revoke was eliminated from the deeds, and thereby canceled and surrendered, in July, 1925.

In the meanwhile Congress had passed the Revenue Act of 1924 which included among its provisions a tax upon gifts. "For the calendar year 1924 and each calendar year thereafter . . . a tax . . . is hereby imposed upon the transfer by a resident by gift during such calendar year of any property wherever situated, whether made directly or indirectly," the tax to be assessed in accordance with a schedule of percentages upon the value of the property.

At the date of the cancellation of the power of revocation, the value of the securities constituting the corpus of the two trusts was nearly $13,000,000. Upon this value the Commissioner assessed against the donor a tax of $2,465,681, which the Board of Tax Appeals confirmed with a slight modification due to a mistake in computation. The taxpayer appealed to the Court of Appeals for the second circuit, which reversed the decision of the Board and held the gift exempt. 58 F.(2d) 188. The case is here on certiorari.

On November 8, 1924, more than eight months before the cancellation of the power of revocation, the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, adopted and promulgated the following regulation:

> The creation of a trust, where the grantor retains the power to revest in himself title to the corpus of the trust, does not constitute a gift subject to tax, but the annual income of the trust which is paid over to the beneficiaries shall be treated as a taxable gift for the year in which so paid. Where the power retained by the grantor to revest in himself title to the corpus is not exercised, a taxable transfer will be treated as taking place in the year in which such power is terminated.

The substance of this regulation has now been carried forward into [§501(c) of] the Revenue Act of 1932. . . .

We think the regulation, and the later statute continuing it, are declaratory of the law which Congress meant to establish in 1924.

"Taxation is not so much concerned with the refinements of title as it is with the actual command over the property taxed — the actual benefit for which the tax is paid." Corliss v. Bowers, 281 U.S. 376, 378. . . . While the powers of revocation stood uncanceled in the deeds, the gifts, from the point of view of substance, were inchoate and imperfect. By concession there would have been no gift in any aspect if the donor had attempted to attain the same result by the mere delivery of the securities into the hands of the donees. A power of revocation accompanying delivery would have made the gift a nullity. Basket v. Hassell, 107 U.S. 602. By the execution of deeds and the creation of trusts, the settlor did indeed succeed in divesting himself of title and transferring it to others . . . but the substance of his dominion was the same as if these forms had been omitted. Corliss v. Bowers, supra. He was free at any moment, with reason or without, to revest title in himself, except as to any income then collected or accrued. As to the principal of the trusts and as to income to accrue thereafter, the gifts were formal and unreal. They acquired substance and reality for the first time in July, 1925, when the deeds became absolute through the cancellation of the power.

The argument for the respondent is that Congress in laying a tax upon transfers by gift made in 1924 or in any year thereafter had in mind the passing of title, not the extinguishment of dominion. In that view the transfer had been

made in 1917 when the deeds of trust were executed. The argument for the Government is that what was done in 1917 was preliminary and tentative, and that not till 1925 was there a transfer in the sense that must have been present in the mind of Congress when laying a burden upon gifts. Petitioner and respondent are at one in the view that from the extinguishment of the power there came about a change of legal rights and a shifting of economic benefits which Congress was at liberty, under the Constitution, to tax as a transfer effected at that time. . . . The question is not one of legislative power. It is one of legislative intention.

With the controversy thus narrowed, doubt is narrowed too. Congress did not mean that the tax should be paid twice, or partly at one time and partly at another. If a revocable deed of trust is a present transfer by gift, there is not another transfer when the power is extinguished. If there is not a present transfer upon the delivery of the revocable deed, then there is such a transfer upon the extinguishment of the power. There must be a choice, and a consistent choice, between the one date and the other. To arrive at a decision, we have therefore to put to ourselves the question, which choice is it the more likely the Congress would have made? Let us suppose a revocable transfer made on June 3, 1924, the day after the adoption of the Revenue Act of that year. Let us suppose a power of revocation still uncanceled, or extinguished years afterwards, say in 1931. Did Congress have in view the present payment of a tax upon the full value of the subject matter of this imperfect and inchoate gift? The statute provides that upon a transfer by gift the tax upon the value shall be paid by the donor and shall constitute a lien upon the property transferred. By the act now in force, the personal liability for payment extends to the donee.* A statute will be construed in such a way as to avoid unnecessary hardship when its meaning is uncertain. Hawaii v. Mankichi, 190 U.S. 197, 214; Sorrels v. United States, 287 U.S. 435. Hardship there plainly is in exacting the immediate payment of a tax upon the value of the principal when nothing has been done to give assurance that any part of the principal will ever go to the donee. The statute is not aimed at every transfer of the legal title without consideration. Such a transfer there would be if the trustees were to hold for the use of the grantor. It is aimed at transfers of the title that have the quality of a gift, and a gift is not consummate until put beyond recall.

The respondent invokes the rule that in the construction of a taxing act doubt is to be resolved in favor of the taxpayer. United States v. Merriam, 263 U.S. 179; Gould v. Gould, 245 U.S. 151. There are many facets to such a maxim. One must view them all, if one would apply it wisely. The construction that is liberal to one taxpayer may be illiberal to others. One must strike a balance of advantage. It happens that the taxpayer before us made his deeds in 1917, before a transfer by gift was subject to a tax. We shall alleviate his burden if we say that the gift was then complete. On the other hand, we shall be heightening the burdens of taxpayers who made deeds of gift after the Act of 1924. In making them, they had the assurance of a treasury regulation that the tax would not be laid, while the power of revocation was uncanceled, except upon the income paid from year to year. They had good reason to suppose that the tax upon the principal would not be due until the power was extinguished or until the principal was paid. If we disappoint their expectations, we shall be illiberal to them.

The tax upon gifts is closely related both in structure and in purpose to the tax upon those transfers that take effect at death. What is paid upon the one

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* The corresponding provisions of the 1954 Code are §2502(d) (donor to pay tax) and §6324(b) (gift tax lien; donee personally liable to the extent of the value of the gift). — Ed.

is in certain circumstances a credit to be applied in reduction of what will be due upon the other.* The gift tax is Part II of Title III of the Revenue Act of 1924; the Estate Tax is Part I of the same title. The two statutes are plainly in pari materia. There has been a steady widening of the concept of a transfer for the purpose of taxation under the provisions of Part I. . . . There is little likelihood that the lawmakers meant to narrow the concept, and to revert to a construction that would exalt the form above the substance, in fixing the scope of a transfer for the purposes of Part II. We do not ignore differences in precision of definition between the one part and the other. They cannot obscure identities more fundamental and important. The tax upon estates, as it stood in 1924, was the outcome of a long process of evolution; it had been refined and perfected by decisions and amendments almost without number. The tax on gifts was something new. Even so, the concept of a transfer, so painfully developed in respect of taxes on estates, was not flung aside and scouted in laying this new burden upon transfers during life. Congress was aware that what was of the essence of a transfer had come to be identified more nearly with a change of economic benefits than with technicalities of title. The word had gained a new color, the result, no doubt in part, of repeated changes of the statutes, but a new color none the less. . . .

The respondent finds comfort in the provisions of §302(d) of the Act of 1924 [providing that in computing the federal estate tax there shall be included in the gross estate the corpus of any trust created by the decedent during his lifetime "where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power, either by the decedent alone or in conjunction with any person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death, except in case of a bona fide sale for a fair consideration in money or money's worth," a provision which was applicable to trusts whether created before or after the enactment of the 1924 Act]. He asks why such a provision should have been placed in Part I [estate tax] and nothing equivalent inserted in Part II [gift tax], if powers for purposes of the one tax were to be treated in the same way as powers for the purposes of the other. Section 302(d) of the Act of 1924 is in part a reënactment of a section of the Revenue Acts of 1918 and 1921, though it has been changed in particulars. . . . It is an outcome of that process of development which has given us a rule for almost every imaginable contingency in the assessment of a tax under the provisions of Part I. No doubt the draftsman of the statute would have done well if he had been equally explicit in the drafting of Part II. This is not to say that meaning has been lost because extraordinary foresight would have served to make it clearer. Here as so often there is a choice between uncertainties. We must be content to choose the lesser. To lay the tax at once, while the deed is subject to the power, is to lay it on a gift that may never become consummate in any real or beneficial sense. To lay it later on is to unite benefit with burden. We think the voice of Congress has ordained that this be done. . . .

The argument for the respondent, if pressed to the limit of its logic would carry him even farther than he had claimed the right to go. If his position is sound that a power to revoke does not postpone for the purpose of taxation the consummation of the gift, then the income of these trusts is exempt from the tax as fully as the principal. What passed to the beneficiaries was the same in either case, an interest inchoate and contingent till rendered absolute and consummate through receipt or accrual before the act of revocation. Congress did not mean

* See §2012 (credit for federal gift tax paid on property included in gross estate), infra page 1330. — Ed.

that recurring instalments of the income, payable under a revocable conveyance which had been made by a settlor before the passage of this statute, should be exempt, when collected, from the burden of the tax.

The judgment is reversed.

THE CHIEF JUSTICE took no part in the consideration or decision of this case.

MR. JUSTICE SUTHERLAND and MR. JUSTICE BUTLER are of opinion that the termination of the donor's power of revocation was not a transfer by gift of any property within the meaning of the statute, and that the judgment of the Circuit Court of Appeals should be affirmed.

NOTE

1. *Repeal of §501(c), 1932 Act.* Because the Supreme Court in the *Guggenheim* case expressed the opinion that §501(c) of the 1932 Revenue Act (providing that a revocable transfer is not a taxable gift) was declaratory only, it was repealed in 1934.

2. *Transfers revocable because of transferor's incompetence, etc.* A gift may be subject to recall because the donor was non compos mentis, because he failed to make an effective delivery of the property or to comply with laws like the statute of frauds, because the transfer was procured by fraud, and so on. Is there a taxable gift if there is no time limit on the power of the donor to recover the donated property? If the transfer has not been nullified at the time of the donor's death, the property may be part of his gross estate and become subject to the federal estate tax. See page 1082 infra.

In Commissioner v. Allen, 108 F.2d 961, cert. denied, 309 U.S. 680 (1940), the court had to decide the proper time for imposing the gift tax on a transfer made by the taxpayer while he was a minor. The applicable local law allowed a minor to recover property transferred by gift at any time before reaching the age of 21 and for a "reasonable time" (depending "on the circumstances of the particular case") thereafter. The transfer occurred in 1932, before the gift tax law was enacted; the government assessed a deficiency for 1933, when the taxpayer became 21. The court rejected the taxpayer's argument that the gift was made in 1932 and upheld the assessment for 1933. But there was no contention that the gift occurred in a *later* year:

> The respondent [taxpayer] suggests that a ruling, that a minor's transfer in trust does not become taxable until the minor attains majority and fails to disaffirm, will lead to difficulties in administration with respect to the date of taxability of a transfer in view of the varying periods allowed minors for disaffirmance after majority. No such difficulty arises from the record in this case. The respondent objected neither to the Commissioner's determination of the date the transfer became complete as a gift nor to the valuation placed upon the securities embraced by the transfer. Moreover, the period of the New Jersey statute of limitations, the utter conceivable limit of the respondent's right to disaffirm, expired on October 9, 1939, without an effort at disaffirmance on her part. In any event, for the Commissioner to promulgate a regulation with respect to a minor's transfer in trust that will fully protect the minor's free exercise of his right to disaffirm after majority should not present insuperable difficulty. [108 F.2d at 966.]

No regulation of this type has been issued.

See also Richardson v. Commissioner, 126 F.2d 562 (2d Cir. 1942) (taxpayer took certain steps to transfer stock to his wife as a gift before gift tax law was enacted, but did not deliver certificates to her until after law's enactment; held, preliminary steps did not constitute gift, because certificates and certain other documents remained in possession of taxpayer's agent and taxpayer's action was revocable). Does state or federal law govern the effectiveness of the ceremonial conduct (delivery, etc.) evidencing the completion of a gift? In the *Richardson* case, the court (per Judge Jerome N. Frank) said that "we are not here compelled by Erie R. Co. v. Tompkins, 304 U.S. 64, to play the role of ventriloquist's dummy to the courts of some particular state; as we understand it, 'federal law,' not 'local law,' is applicable." But what is the source of federal law on whether there has been an adequate delivery or other transfer of property?

3. *Transfers conditioned on non-taxability.* In Commissioner v. Procter, 142 F.2d 824 (4th Cir. 1944), the court had to pass on the effect of a transfer of property under which title was to revert to the donor should the transfer be determined to be subject to federal gift tax:

> The third point is based upon the following provision of the trust indenture making the gift, viz.:
>
> "Eleventh: The settlor is advised by counsel and satisfied that the present transfer is not subject to Federal gift tax. However, in the event it should be determined by final judgment or order of a competent federal court of last resort that any part of the transfer in trust hereunder is subjected to gift tax, it is agreed by all the parties hereto that in that event the excess property hereby transferred which is decreed by such court to be subject to gift tax, shall automatically be deemed not to be included in the conveyance in trust hereunder and shall remain the sole property of Frederic W. Procter free from the trust hereby created."
>
> We do not think that the gift tax can be avoided by any such device as this. Taxpayer has made a present gift of a future interest in property. He attempts to provide that, if a federal court of last resort shall hold the gift subject to gift tax, it shall be void as to such part of the property given as is subject to the tax. This is clearly a condition subsequent and void because contrary to public policy. A contrary holding would mean that upon a decision that the gift was subject to tax, the court making such decision must hold it not a gift and therefore not subject to tax. Such holding, however, being made in a tax suit to which the donees of the property are not parties, would not be binding upon them and they might later enforce the gift notwithstanding the decision of the Tax Court. It is manifest that a condition which involves this sort of trifling with the judicial process cannot be sustained.
>
> The condition is contrary to public policy for three reasons: In the first place, it has a tendency to discourage the collection of the tax by the public officials charged with its collection, since the only effect of an attempt to enforce the tax would be to defeat the gift. In the second place, the effect of the condition would be to obstruct the administration of justice by requiring the courts to pass upon a moot case. If the condition were valid and the gift were held subject to tax, the only effect of the holding would be to defeat the gift so that it would not be subject to tax. The donor would thus secure the opinion of the court as to the taxability of the gift, when there would be before the court no controversy whatever with the taxing authorities which the court could decide, the only possible controversy being as to the validity of the gift and being between the donor and persons not before the court. . . .
>
> In the third place the condition is to the effect that the final judgment of a court is to be held for naught because of the provision of an indenture necessarily before the court when the judgment is rendered. It should be remembered that it is not possible to obtain a declaratory judgment from a federal court as to whether the gift in question is subject to the gift tax.* The only way, therefore, in which it could be determined by "final judgment" of a federal court of last resort that any part of a transfer was subject to a gift tax would be for a tax to be assessed by the Commissioner and upheld by such court in the course of legal proceedings instituted for its enforcement or for its recovery after payment. This final judgment would fix the liability of the donor for the tax; and only then could the condition become operative. The condition, however, could not be given the effect of invalidating a judgment which had been rendered when the instrument containing the condition was before the court, since all matters are merged in the judgment. To state the matter differently, the condition is not to become operative until there has been a judgment; but after the judgment has been rendered it cannot become operative because the matter involved is concluded by the judgment. [142 F.2d at 827.]

Harrison v. Commissioner, 17 T.C. 1350 (1952), involved a gift in trust under which the trustee was to pay out of the corpus any gift tax levied on the transfer. The Court held:

* Supra page 927. — Ed.

One of the essential elements of a gift is the donor's intent to make the gift. Petitioner did not intend that the amount of the value of the property necessary for the gift tax liability would be a gift to the trust. Therefore, in the absence of an intent to give, this amount was not effective as property passing from the donor, and not taxable as a gift. [17 T.C. at 1357.]

See also page 921 supra.

HOLTZ'S ESTATE v. COMMISSIONER
38 T.C. 37 (1962)

DRENNAN, Judge: . . .

The principal issue for decision is whether taxable gifts resulted from transfers to a trust established by [Leon Holtz, the decedent] by deed of trust dated June 12, 1953, wherein Leon was the settlor and Land Title Bank and Trust Company, now Provident Tradesmens Bank and Trust Company, was the sole trustee. The trust instrument provided that the trustee should distribute the net income therefrom and the principal thereof as follows. During the lifetime of settlor the income should be paid to him, and as much of the principal as the trustee "may from time to time think desirable for the welfare, comfort and support of Settlor, or for his hospitalization or other emergency needs," should be paid to him or for his benefit. Upon the death of the settlor, if his wife survived him, the income of the trust was to be paid to her during her lifetime, and a similar provision was made for invasion of principal for her benefit during her lifetime. The trust was to terminate at the death of the survivor of settlor and his wife and the "then-remaining principal" was payable to the estate of the survivor.

On June 12, 1953, Leon transferred property having a value of $384,117 to the trust, and on January 18, 1955, he transferred an additional $50,000 in cash to the trust. Respondent determined that, as a result of these transfers, Leon made taxable gifts in 1953 in the amount of $263,277.63, and in 1955 in the amount of $35,570, computing the value of the taxable gifts by reducing the value of the property transferred in each instance by the actuarial value of Leon's life estate and reversionary interest in each transfer. Petitioner claims the transfers were not completed gifts and that no part of the value thereof was subject to gift tax.

At the trial of this proceeding respondent moved that the testimony of the trustee's agent concerning the circumstances surrounding the creation and execution of the trust be stricken from the record on the ground that the written trust instrument contained the entire agreement of the parties and that any parol evidence which varied, explained, or otherwise colored the terms of the instrument was inadmissible under the parol evidence rule. The motion was taken under advisement at the conclusion of the trial and the parties were asked to argue the motion on brief. Respondent did not mention his motion on brief and we assume he has abandoned it. However, it is well established in this Court that the parol evidence rule cannot be invoked by a third party, not a party to the written instrument involved, Haverty Realty & Investment Co., 3 T.C. 161 (1944), and cases cited therein; Sarah Helen Harrison, 17 T.C. 1350 (1952); and, furthermore, one of the exceptions to the parol evidence rule is that parol evidence may be received not to contradict or vary the terms of the written contract but to explain how it is to be carried out. American Crystal Sugar Co. v. Nicholas, 124 F.2d 477 (C.A. 10, 1941). Respondent's motion to strike the oral evidence is denied.

The Internal Revenue Codes of 1939 and 1954 provide no guideposts for determining when a gift becomes complete for gift tax purposes beyond the direction [§2511(a)] that "the tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal,

tangible or intangible." It is well settled in cases involving this issue, however, that the question whether a transfer in trust is a completed gift, and thus subject to gift tax, turns on whether the settlor has abandoned sufficient dominion and control over the property transferred to put it beyond recall. Burnet v. Guggenheim, 288 U.S. 280 (1933); Estate of Sanford v. Commissioner, 308 U.S. 39 (1939); Smith v. Shaughnessy, 318 U.S. 176 (1943).

Here we do not have a situation where the settlor either reserved the power in himself alone to modify, alter, or revoke the trust and thus revest the trust property in himself, as in Burnet v. Guggenheim, supra, or reserved the power to alter the disposition of the property or income therefrom in some way not beneficial to himself, as in Estate of Sanford v. Commissioner, supra, or reserved the power in conjunction with someone else to modify, alter, or revoke the trust, as in Camp v. Commissioner, 195 F.2d 999 (C.A. 1, 1952), reversing in part 15 T.C. 412 (1950). Leon reserved no rights in himself to change the disposition of the income or principal of the trust as fixed in the trust agreement. However, the trust agreement itself gave the trustee power to pay directly to Leon or for his benefit as much of the principal of the trust as the trustee thought desirable for Leon's welfare, comfort, and support, or for his hospitalization or other emergency needs. The question is whether this discretionary power placed in the trustee by the settlor under the terms of the trust agreement made the gifts of the remainder interests incomplete for gift tax purposes.

A number of cases decided by this and other courts have held that the placing of discretionary power in the trustee to invade corpus makes the gift of corpus incomplete under certain circumstances. The rule of thumb generally accepted seems to be that if the trustee is free to exercise his unfettered discretion and there is nothing to impel or compel him to invade corpus, the settlor retains a mere expectancy which does not make the gift of corpus incomplete. Herzog v. Commissioner, 116 F.2d 591 (C.A. 2, 1941), affirming 41 B.T.A. 509 (1940). But if the exercise of the trustee's discretion is governed by some external standard which a court may apply in compelling compliance with the conditions of the trust agreement, and the trustee's power to invade is unlimited, then the gift of corpus is incomplete, Commissioner v. Irving Trust Co., 147 F.2d 946 (C.A. 2, 1945), affirming 2 T.C. 1052 (1943), and this is true even though such words as "absolute" and "uncontrolled" are used in connection with the trustee's discretion, provided the external standards are clearly for the guidance of the trustee in exercising his discretion. Estate of John J. Toeller, 6 T.C. 832 (1946), affd. 165 F.2d 665 (C.A. 7, 1948); Estate of Lelia E. Coulter, 7 T.C. 1280 (1946).

The theory behind this rule seems to be that by placing such standards for guidance of the trustee's discretion in the trust agreement itself, the settlor has not actually lost all dominion and control of the trust corpus or put it completely beyond recall because to ignore the implications and purpose for writing the standards into the invasion clause would be an abuse of discretion on the part of the trustee which the trustee would neither desire to do nor be likely to risk doing under State laws; see Estate of Christianna K. Gramm, 17 T.C. 1063 (1951); Estate of John J. Toeller, supra; or because by borrowing money and relegating his creditors to the trustee for satisfaction of their debts the settlor could have effective use of the corpus for his own benefit,[1] see Alice Spaulding Paolozzi, 23 T.C.

[1] The rights of creditors to reach the income and/or principal of a discretionary trust for satisfaction of their claims against the settlor may not be the same in all States. Compare Sarah Gilkey Vander Weele, 27 T.C. 340 (1956), affd. 254 F.2d 895 (C.A. 6, 1958), involving Michigan law, and Alice Spaulding Paolozzi, 23 T.C. 182 (1954), involving Massachusetts law, with Herzog v. Commissioner, 116 F.2d 591 (C.A. 2, 1941), affirming 41 B.T.A. 509 (1940), involving New York law. See also Restatement, Trusts, sec. 156(2) [creditors of a person creating a discretionary trust

182 (1954); Sarah Gilkey Vander Weele, 27 T.C. 340 (1956), affd. 254 F.2d 895 (C.A. 6, 1958).

The rule of thumb appears to be a reasonable application of the general rule established in the *Guggenheim, Sanford,* and *Shaughnessy* cases because where there is a reasonable possibility that the entire corpus might be repaid to the settlor there can be no assurance that anyone else will receive anything in the form of a gift, and if the corpus should happen to be kept intact until the settlor's death, even though the transfer in trust was not subjected to a gift tax, the corpus of the trust will in all likelihood be subjected to the estate tax in the settlor's estate. See Estate of John J. Toeller, supra; Estate of Lelia E. Coulter, supra.

Applying the above principles to the facts under consideration here, we conclude that no part of or interest in the property transferred to the trust constituted a completed gift for gift tax purposes when transferred to the trust.

The form of the trust agreement indicates that the principal beneficiary of the income, and the principal if it became desirable for his welfare, comfort, support, or emergency needs, was the settlor. The first instructions to the trustee, as shown by the part of the deed of trust quoted in our Findings of Fact, were to distribute net income and principal to the settlor during his lifetime. Only upon the death of the settlor, and if she survived him, was any provision made for payment of either income or principal to the settlor's wife. And only upon the death of the survivor of settlor and his wife was any provision made for distribution of the "then-remaining principal." The trustee had the unfettered power to use all of the corpus for the benefit of settlor, if it thought that it was desirable for the welfare, comfort, or needs of the settlor. The words used were broad enough to cover about anything Leon might want or need. It is reasonable to assume that the trustee would invade corpus and that it would be required to do so by a court if the welfare, comfort, or needs of the settlor made it seem desirable. Otherwise, there would not have been much reason for including the paragraph giving the trustee power to invade principal. It was entirely possible that the entire corpus might be distributed during the settlor's lifetime and no one other than the settlor would receive any portion thereof. As long as that possibility was present, by reason of the language employed by the settlor, the settlor had not abandoned sufficient dominion and control over the property transferred to make the gift consummate. Estate of John J. Toeller, supra.

In addition to the trust agreement itself, the evidence indicates that the settlor, who was 80 years of age when the trust was established, expressed concern over whether he would have available sufficient funds to meet his needs. He asked the trust officer whether he would have enough money to buy an automobile and the trust officer reassured him by telling him that the trust agreement provided for the payment of all income to him and that he could also have money out of the principal, and that the trustee would be liberal in giving him money out of the principal. While the term "liberal" is not defined, the above conversation indicates the understanding of the parties was that the trustee recognized that principal should be distributed at any time the settlor's needs reasonably justified it.

The evidence also indicates that one reason Leon established the trust was because he was having difficulty managing the property placed in the trust. The original property transferred to the trust consisted of approximately 200 small mortgages which had been kept in a metal container in Leon's basement, the

can reach the maximum amount which the trustee could pay to him or apply for his benefit]. While we do not rely on this theory and hence are not called upon to interpret the Pennsylvania law, a cursory examination of the law of that State would indicate it would follow the rule in Michigan and Massachusetts that will not permit a settlor to place property in trust for his own benefit and keep it beyond the reach of creditors. . . .

records on which the trustee discovered to be very inaccurate and inadequate. It is probable that management of the trust property was more of a motivating factor for Leon's establishment of the trust than a desire to put what appears to have been a considerable part of his remaining property completely beyond his reach.

While the language used in the trust instruments and the surrounding circumstances involved in the *Vander Weele* and *Gramm* cases were a little different than the language used in this trust instrument and the circumstances here involved, we think they were close enough to compel the conclusion we reach here. We do not believe respondent's argument that because of Leon's wealth it was very unlikely that the trustee would ever be called upon to use much of the corpus is well founded. It appears from the evidence that when Leon established this trust he had given away most of his property.

Decision will be entered for the petitioner.

NOTE

1. *Discretionary power to revest transferred property.* Does the court hold that a transfer in trust is not a "gift" if "there is a reasonable possibility that the entire corpus might be repaid to the settlor"? What if no standards were set out in the trust instrument to govern the trustee's exercise of discretion? Should the trustee's testimony regarding the establishment of the trust have been admitted if it would have been excluded in an action by the settlor against the trustee to compel an exercise of the trustee's power in favor of the settlor? Would the government be entitled to ask the trustee whether the power to revest the corpus in the settlor would have been exercised "liberally" or "generously" had the settlor requested such action?

On the likelihood that a trustee will be responsive to the settlor's desires, a commentator has said:

> Even a corporate fiduciary may be susceptible to pressure from the grantor in its exercise of discretionary powers as trustee. The grantor may be a customer of the commercial department as well as the trust department, or the corporate fiduciary may anticipate serving as executor of the grantor's estate and as trustee under his will if no untoward development should mar the relationship. Quite apart from such specific pressures is the more general one that arises from the nature of a fiduciary's business. As the name implies, it is engaged in the administration of trusts. A reputation in the community for being hard to get along with is unlikely to assist the work of the new business department. [Westfall, Trust Grantors and Section 674: Adventures in Income Tax Avoidance, 60 Colum. L. Rev. 326, 340 (1960).]

See also the *Gramm* case, cited by the court, involving a trust instrument which, as originally drafted, permitted an invasion of corpus for the benefit of the settlor only if the remainderman consented; the corporate trustee recommended a revision of the instrument to permit it to act without consent of the remainderman because "we would be very reluctant to act as a corporate trustee under [the instrument in its original form] inasmuch as it did not give us the right to take care of our customer, Mrs. Gramm."

Does Holtz's Estate v. Commissioner invite a prediction in each case of the manner in which the trustee will exercise its powers to invade the corpus?

See Rev. Rul. 62-13, 1962-1 C.B. 181, withdrawing the Service's previously announced nonacquiescence in the *Gramm* and *Vander Weele* case, cited by the court, and substituting an acquiescence in both cases; Clement v. Smith, 167 F. Supp. 369 (E.D. Pa. 1958) (son created trust to pay income to his father for support if trustees deemed this advisable; held, on the facts, possibility of such payments so speculative as not to constitute a gift).

2. *Transfers that can be reached by transferor's creditors.* If under local law the settlor's creditors can reach the transferred property because the trustee may exercise its power in his favor (see footnote 1 of the opinion), is the transfer incomplete? Does the answer depend on the likelihood that the settlor will incur, and fail to pay, obligations at a rate that might exhaust the corpus of the trust?

On the status of trusts to discharge the settlor's legal obligations, see page 1035 infra.

3. *Discretionary power vested in adverse party.* In *Holtz's Estate,* the discretionary power was vested in a "neutral" trustee. For the gift tax consequences if such a power is vested in the remainderman or other beneficiary of the trust, see page 1164 infra.

4. *Relation to estate tax.* For the estate tax treatment of transfers like those in *Holtz's Estate, Gramm,* and *Vander Weele,* see page 1163 infra.

LOCKARD v. COMMISSIONER

166 F.2d 409 (1st Cir. 1948)

Before MAGRUDER, MAHONEY and WOODBURY, Circuit Judges.

MAGRUDER, Circuit Judge.

Barbara M. Lockard petitions for review of a decision of the Tax Court of the United States determining that "there is a deficiency in gift tax of $5,517.39 for the year 1941." 7 T.C. 1151.

Petitioner undoubtedly made a taxable gift in 1941. In her return she claimed the full $40,000 specific exemption. [§1004, 1939 Code.]* The Commissioner disallowed this exemption to the extent of $22,595.95 on the ground that petitioner had claimed and been allowed an exemption of $19,363.93 in respect of a taxable gift made in 1938 and an exemption of $3,232.02 in respect of a taxable gift made in 1939. Petitioner now contends that she erroneously reported taxable gifts in 1938 and 1939, and therefore that no part of the specific exemption was properly consumed in either year. It is conceded by the Commissioner that the amounts which were claimed as exemptions in 1938 and 1939 were "allowed" within the meaning of [§2521] — and thus pro tanto exhausted the $40,000 specific exemption — only if the taxpayer made taxable gifts in those years. Schuhmacher v. Commissioner, 8 T.C. 453, 464 (1947); Schmidlapp v. Commissioner, 1941, 43 B.T.A. 829. On this branch of the case the question is whether the beneficiary's irrevocable right to receive the income from the corpus of a short term trust constitutes a taxable gift in the year in which the property is transferred to the trust, notwithstanding the fact that the settlor may remain taxable on such income under the doctrine of Helvering v. Clifford [supra p. 372].

On March 30, 1938, the petitioner created an irrevocable trust, with herself and another as cotrustees, under the terms of which the entire net income was directed to be paid to Derwood W. Lockard, her husband, for a term of six years; and upon April 1, 1944, or if the husband should die earlier, then on the date of his death, the principal was to revert to the settlor, free of trust. On March 30, 1939, the petitioner transferred additional property to the trust.

The Tax Court held that the transfers in trust in 1938 and 1939 constituted taxable gifts to Mr. Lockard, in those years, of the right to receive the income for a term of years; and therefore that the amounts of specific exemption claimed by petitioner in her gift tax returns for those two years, and allowed by the Commissioner, must be deducted from the $40,000 specific exemption claimed by her in her return of the 1941 gift. We agree with this conclusion. Valuation of these gifts in 1938 and 1939 is covered by stipulation and is not in dispute.

Section [2511(a)] provides that the gift tax is applicable "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible." That the broad sweep of this language was not inadvertent is emphasized in the committee reports. H.R. Rep. No. 708, 72d Cong., 1st Sess., at p. 27, stated: "The terms 'property,' 'transfer,' 'gift,' and 'indirectly' are used in the broadest and most comprehensive sense; the term 'property' reaching every species of right or interest protected by law and

* The exemption is now only $30,000. §2521. — ED.

having an exchangeable value." See to the same effect Sen. Rep. No. 665, 72d Cong., 1st Sess., p. 39. See also Smith v. Shaughnessy, 1943, 318 U.S. 176, 180, in which the court states that the amplitude of legislative purpose, thus expressed, "is broad enough to include property, however conceptual or contingent."

By the transfer in trust in 1938, Mr. Lockard acquired an equitable right to the income from the property for a period of six years, subject only to his earlier death. He then received a legally protected interest "having an exchangeable value"; and the commuted value of this right of future income is readily calculable. Helvering v. McCormack, 2 Cir., 1943, 135 F.2d 294, 296. See art. 19(7) of Regulations 79 (1936 Ed.). To the extent of this interest, the settlor abandoned control of the property upon its transfer in trust. Not only did the settlor reserve no power to revoke, and revest in herself, the beneficial interest thus donated; she could not even modify the donee's interest or shift the benefit, in whole or in part, to another. The transfer, therefore, meets every test of taxability under the language of the Act and under the criteria laid down in Smith v. Shaughnessy, supra. The same may be said of the additional transfer to the trust made in 1939.

The foregoing conclusion would have seemed inevitable and inescapable if one had never heard of Helvering v. Clifford, a case involving income tax liability. It is recited in the stipulation in the case at bar that the distributable trust income for the years 1938-1941, inclusive, was included by the Commissioner in the income of Mrs. Lockard under I.R.C. §22(a) [§61(a), 1954 Code], as interpreted in the *Clifford* case. Exegesis of Helvering v. Clifford has proceeded apace, and not without difficulty, in a large volume of subsequent litigation in the lower federal courts. . . . No doubt there would be many judicial sighs if the great body of *Clifford* learning had to be imported into gift tax litigation. But as this court held in Commissioner v. Prouty, 1 Cir., 1940, 115 F.2d 331, 337, "the gift tax does not seem to be so closely integrated with the income tax that decisions like the *Clifford* case extending the applicability of Section 22(a) [§61(a), 1954 Code] to the grantor of a trust, must necessarily be read as holding that no gift tax was payable upon the creation of the trust." [1] We tried to point out again, at considerable length, in Higgins v. Commissioner, 1 Cir., 1942, 129 F.2d 237, certiorari denied 1942, 317 U.S. 658, that under existing provisions of law respecting income, gift and estate taxes, it is quite impossible for the courts to achieve a complete integration of these three taxes. Chief Justice Stone made an apparent effort in Estate of Sanford v. Commissioner, 1939, 308 U.S. 39, to bring about a measure of correlation between the gift tax and the estate tax, by his statement, page 44 of 308 U.S., that the test of completeness of a transfer for purposes of the gift tax is no different "from that to be applied in determining whether the donor has retained an interest such that it becomes subject to the estate tax upon its extinguishment at death." Cf. Higgins v. Commissioner, supra, 1 Cir., 129 F.2d at page 240-242. But in Smith v. Shaughnessy, 1943, 318 U.S. 176, the Supreme Court disavowed any intention to intimate in the *Sanford* case that there was "a general policy against allowing the same property to be taxed both as an estate and as a gift," page 178 of 318 U.S.; and pointed out that the plan of Congress for integrating the estate and gift taxes is to be found in the provision of law granting a credit on estate taxes by reason of previous payment of gift taxes on the same property* — a "system of secured payment on gifts which will later be subject to the estate tax," page 179 of 318 U.S. Aside from this, it seems that for the most part any correlation that may exist between the three taxes is "purely coincidental."

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1 In fact, in the *Clifford* case itself, in which the income of a particular short term trust was held taxable to the settlor-trustee, the Court noted (309 U.S. at page 333) that the settlor had paid a federal gift tax upon the transfer in trust.

* Infra page 1330. — Ed.

Petitioner does not contend that there is a complete integration between the income tax and gift tax, so that the mere fact that a transfer leaves the transferor still liable to income tax on the property always negatives a gift tax liability; but she does argue that the same question of fact underlies both liability for income tax under the *Clifford* rule, and liability for gift tax — namely, whether the settlor, after the transfer in trust, remains in substance the owner of the corpus. If, notwithstanding the transfer, the settlor is deemed to remain in substance the owner of the corpus, the income therefrom — the fruit of the tree — is, for income tax purposes, attributable to the settlor, and the settlor does not escape an income tax thereon "by any kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another, since, by the exercise of his power to command the income, he enjoys the benefits of the income on which the tax is laid." Harrison v. Schaffner, 1941, 312 U.S. 579, 582. See Commissioner v. Bateman, 1 Cir., 1942, 127 F.2d 266, 271-274. Petitioner argues from this that, for income tax purposes, the result is the same as if the settlor of the short term trust had continued to receive the income yearly and had made a series of assignments of such income. It is contended, further, that similar treatment for gift tax purposes is appropriate, so that no gift tax should be payable when the trust is created, but actual payments of income to the beneficiary should be taxable as gifts when such payments are made from year to year.* This suggested mode of treatment may be appropriate and reasonable; the only trouble with it is that it is not sanctioned by the statutory scheme. As we have already pointed out, the income tax and gift tax each has its own independent criteria of taxability. In the trust now before us it may be true, under Helvering v. Clifford, that for income tax purposes the result is the same as if Mrs. Lockard had herself received the income each year and had made a series of assignments of it to her husband. But the fact is that she did not receive the income and then give it away by successive assignments. Upon creating the trust she made a single transfer whereby her husband then and there acquired an irrevocable right to the income for a period of years. Under the plain language of the gift tax, and under the authorities above cited, this intangible right to future income must be valued as of the date of the transfer in trust, and taxed to the donor. . . .

A judgment will be entered affirming the decision of the Tax Court.

NOTE

1. *Other aspects of correlation with income tax.* In Strong v. Commissioner, 7 T.C. 953 (1946), it was held that the creation of a family partnership was not a taxable gift. In an earlier income tax proceeding, the Tax Court had refused to give tax effect to the partnership on the ground that certain purported transfers of business interests were not "valid gifts." When gift tax liability was asserted, the Tax Court held that the principle of res judicata was applicable: "In other words, the Commissioner, having secured a holding in the prior cases that there were no completed gifts made by the transaction of October 1, 1940, can not now be heard to say, in a proceeding involving the same parties, that there were valid completed gifts made in those transactions." 7 T.C. at 957. (On the use of res judicata in tax cases, see pages 938-943 supra.) One judge dissented and three others thought the doctrine of res judicata was not applicable, but concurred on the ground that in fact no gifts had been made.

Does §704(e), relating to family partnerships and enacted after the *Strong* case was decided, adopt the gift tax conception of a completed transfer in determining the validity of a family partnership under the income tax? Supra page 396.

See Commissioner v. Beck's Estate, 129 F.2d 243 (2d Cir. 1942), holding the grantor

* This is the way the income of a revocable trust is treated. See the last paragraph of Burnet v. Guggenheim, supra page 1007; Commissioner v. Warner, 127 F.2d 913 (9th Cir. 1942). — Ed.

of a trust liable for a gift tax on the entire value of the corpus, although the income was to be used to pay the premiums on insurance on his life and would therefore be taxable to him under §677(a)(3) (supra p. 371). After citing several other cases in which a lack of coordination among the federal income, estate, and gift taxes was recognized, Judge Frank said:

> At the bottom of [taxpayers'] contentions is this implied assumption: The same transaction cannot be a completed gift for one purpose and an incomplete gift for another. Of course, that is not true, as the cases above cited make clear. Perhaps to assuage the feelings and aid the understanding of affected taxpayers, Congress might use different symbols to describe the taxable conduct in the several statutes, calling it a "gift" in the gift tax law, a "gaft" in the income tax law, and a "geft" in the estate tax law. [129 F.2d at 246.]

See also the *Farid-Es-Sultaneh* case, supra page 133; Gault v. Commissioner, 216 F.2d 41 (7th Cir. 1954).

In Stone v. Stone, 319 Mich. 194, 29 N.W.2d 271 (1947), the plaintiffs sued successfully to set aside transfers of partnership assets to their children on the ground of mutual mistake, after the Commissioner decided that the partnership would not be recognized for income tax purposes. Could the transferors then recover any gift taxes paid on the conveyances? Board v. Commissioner, 14 T.C. 322 (1950); see also Lowry v. Kavanagh, 322 Mich. 532, 34 N.W.2d 60 (1948).

In Rev. Rul. 57-315, 1957-2 C.B. 624, the Internal Revenue Service ruled that a transfer similar to the one in White v. Fitzpatrick, supra page 406, was a completed gift, even though the subsequent annual payments would not be deductible business expenses in computing the donor's income tax liability. In so ruling, the Service cited the *Lockard* case.

2. *Value of rights retained by taxpayer in Lockard case.* Another issue in the *Lockard* case was the value, for gift tax purposes, of the 1941 gift. As a result of the 1941 transfer, Mr. Lockard was to receive the income of a trust for life, plus such amounts from principal, not in excess of $3000 in any calendar year, as the trustee "in his uncontrolled discretion shall think necessary for [Mr. Lockard's] comfortable maintenance and support." On Mr. Lockard's death, the corpus was to revert to Mrs. Lockard. The Commissioner valued the gift on the assumption that the trustee would pay Mr. Lockard $3000 per year plus the income from the diminishing corpus. This value was upheld by the Tax Court and the Court of Appeals, primarily because the taxpayer did not advance any reliable actuarial method of computing the value of Mrs. Lockard's reserved right to get the corpus back intact if the trustee should not find it necessary to invade it for Mr. Lockard's "comfortable maintenance and support."

3. *One gift or a series of annual gifts?* In *Lockard,* the court held that a gift was made when the trust was created; see also Rev. Rul. 57-315, 1957-2 C.B. 624. Why would the taxpayer have preferred to treat the transaction as giving rise to a series of annual gifts of the trust income? See also Archbold v. Commissioner, 42 B.T.A. 453 (1940) (promise to make a series of gifts; held, gifts are made annually); Harris v. Commissioner, 178 F.2d 861 (2d Cir. 1949), rev'd on other grounds, infra page 1036.

SECTION C. TRANSFER OF "PROPERTY" BY GIFT: §2501(a)

BRADFORD v. COMMISSIONER
34 T.C. 1059 (1960)

DRENNEN, Judge: Respondent determined a deficiency in gift tax against petitioner. . . .

The single issue is whether petitioner's substitution of her promissory note in the amount of $205,000 for notes of her husband held by a bank in 1938 constituted a taxable gift to her husband in the amount of $205,000 in the year 1938. . . .

[The facts are set out in Bradford v. Commissioner, supra page 89.]

Petitioner contends that the transaction did not constitute a transfer of property by gift within [§2501(a)], because the note executed by petitioner and delivered to the bank was not "property" in her hands, and, further, that even if she did transfer property to her husband by gift in 1938, the value of the property transferred was substantially less than the exemption and exclusion . . . so there is no gift tax liability.

Respondent's position is that the subject of the gift was the entire transaction whereby petitioner's husband was relieved of his indebtedness by the execution and delivery of petitioner's note to the bank, thereby resulting in a transfer of economic benefits which would qualify as a "gift" in the broad and comprehensive sense of that word as used in the statute. . . .

We are of the opinion that the transactions . . . did not constitute a taxable gift from petitioner to her husband in the year 1938 within the purview of the statute. We have found no gift tax cases involving facts similar to those here present, but most gift tax cases must be decided on their own facts anyway. Various general principles have developed through case law and the regulations, and our conclusion is based on the application of some of these principles which seem founded on common sense to the facts in this case.

The gift tax is an excise tax on the transfer of property without adequate and full consideration. Gift tax liability is dependent on the transfer of property by the donor, not the receipt of property by the donee, and the measure of the tax is the value of the property passing from the donor at the time the transfer is completed. Estate of Koert Bartman, 10 T.C. 1073. . . . While the presence of donative intent on the part of the donor is said no longer to be a necessary element to make a transfer subject to gift tax, as it had always been considered to be in the common law connotation of gifts, the transfer must be donative in character, and we think donative intent may still be a material factor in determining whether a taxable gift has been made. See Sarah Helen Harrison, 17 T.C. 1350, 1357. It is true that application of the tax is determined more from the objective facts and circumstances of the transfer and what was accomplished, rather than the subjective motives of the donor, Commissioner v. Wemyss, 324 U.S. 303, but the objective standards used in the tax concept of a gift in effect supply the necessary donative intent of which the donor may not have been conscious. But in any event it seems clear that to constitute a gift for tax purposes there must be a transfer of property owned by the donor with a clear and unequivocal intent on the part of the donor to divest himself presently of the property transferred, and dominion and control thereof. 5 Mertens, Law of Federal Gift and Estate Taxation, secs. 34.01 et seq.

The facts and circumstances surrounding the transaction here involved do not convince us that petitioner intended to divest herself of any property or interest therein owned by her in 1938, or that any of the parties involved anticipated that any of her property would ever be used to satisfy the obligation to the bank. In the first place she did not own property in 1938 that would have come anywhere near satisfying the obligation to the bank,* and she had no prospects of acquiring any except through her husband. Secondly, the entire transaction was arranged by [Mr. Bradford], his collateral was retained as security for petitioner's note, and he testified that it was understood that the bank would look first to his collateral for liquidation of the obligation, and he hoped and expected that the collateral

* According to the findings of fact, Mrs. Bradford's net worth when she executed the note for $205,000 was $15,780. — Ed.

would increase sufficiently in value to cover the entire obligation. [Mr. Bradford] paid the interest on the loan and it is reasonable to assume that all parties involved looked to [Mr. Bradford's] assets and his earning power to liquidate the loan.

This does not mean that petitioner was not obligated on the indebtedness evidenced by her note. We assume the bank could have taken judgment against her on the note had it not been paid, and levied on her property to help satisfy the judgment, and that it probably would have done so had that course of action become necessary. But unless and until such action was taken we do not believe petitioner parted with, or intended to part with, dominion and control of any property owned by her which would give rise to a gift tax.

Granted that [§2501(a)] is comprehensive enough to "include property, however conceptual or contingent," Smith v. Shaughnessy, 318 U.S. 176, and to reach any passage of control over the economic benefits of property, Estate of Sanford v. Commissioner, 308 U.S. 39; nevertheless, no matter how intangible, the donor must own a property right or interest which is capable of being, and is, transferred. Commissioner v. Mills, 183 F.2d 32 (C.A. 9, 1950), affirming 12 T.C. 468. Petitioner transferred no property or interest in property in 1938 but only made a promise to pay in the future if called upon to do so. John D. Archbold, 42 B.T.A. 453. The fact that [Mr. Bradford] may have derived some economic benefit in 1938 as a result of this promise is not controlling. . . .

This case presents a situation different from those present in Estate of Ira C. Copley, 15 T.C. 17, affd. 194 F.2d 364 (C.A. 7, 1952), and Paul Rosenthal, 17 T.C. 1047, reversed on other grounds 205 F.2d 505 (C.A. 2, 1953). In those cases there was a definite obligation to pay a fixed amount, whereas here there was no certainty in 1938 that petitioner would ever have to pay anything.

We hold that petitioner did not make a transfer of property by gift in 1938. Cf., Minnie E. Deal, 29 T.C. 730. We might add, as suggested in D. S. Jackman, 44 B.T.A. 704, that taxation is a practical matter and it seems incredible that a person having a net worth of only $15,780 could make a gift of $205,000.

NOTE

1. *Transfer of "property."* In the *Copley* case, cited by the court, the taxpayer entered into an antenuptial agreement in 1931, under which he agreed to transfer $1 million to his intended bride immediately after their marriage, while she agreed that he should "take over the management [of the fund] to the end that its value may be preserved and made productive," that one half should be returned to him or his estate on her death, and that she would later create a trust for the administration of the fund pursuant to the antenuptial agreement. In 1936 and 1944, the taxpayer transferred $500,000 in notes of a business corporation and $500,000 of preferred stock, respectively, in satisfaction of his obligation. It was held, one judge dissenting, that the 1936 and 1944 transactions were not gifts; the opinion implies, but avoids explicitly holding, that there would have been a taxable gift in 1931, when the antenuptial agreement was executed, if the gift tax had been in effect for that year. For the *Rosenthal* case, also cited by the court, see infra page 1042.

Would the result in the *Bradford* case have been different if in 1938 the wife had executed a promissory note in the amount of $205,000 in favor of her husband and he had endorsed it to the bank in substitution for his own notes? Does the *Bradford* case suggest that the gift tax can be avoided if the method used for transferring funds to an impecunious relative is to endorse his notes and to pay the lender when he defaults?

See also French v. Commissioner, 138 F.2d 254 (8th Cir. 1943); G.C.M. 16460, XV-1 C.B. 369 (gifts of checks and notes); Spiegel's Estate v. Commissioner, supra page 787

(date of charitable contribution, for income tax purposes, when made by check executed in one year but not paid until following year).

2. *Disclaimers and renunciations as gifts.* If the legatee under a will refuses to accept his legacy, with the result that the residuary is increased, has he made a "transfer of property by gift" within the meaning of §2501(a)? What if an intestate successor renounces his share of an intestate estate? See Regs. §25.2511-1(c); Hardenbergh v. Commissioner, 198 F.2d 63 (8th Cir. 1952), cert. denied, 344 U.S. 836; Fuller v. Commissioner, 37 T.C. 147 (1961); Rev. Rul. 56-472, 1956-2 C.B. 21 (executor agreed, before rendition of services, to accept an amount that was less than local law allowed; held, not a gift); Lentz, Income and Gift Tax Effects of Renunciation of a Bequest or Inheritance, 21 N.Y.U. Inst. on Fed. Taxation 313 (1963); Roehner and Roehner, Renunciation As Taxable Gift — An Unconstitutional Federal Tax Decision, 8 Tax L. Rev. 289 (1953); Note, Anticipated Problems Under Proposed Treasury Regulations §25.2511-1(c), 30 Rocky Mt. L. Rev. 48 (1957). See also infra page 1270.

Did the taxpayer in the *Teschner* case (supra p. 346) make a "gift" when he designated his daughter as the recipient of any prize that might be awarded for his essay?

COMMISSIONER v. HOGLE

165 F.2d 352 (10th Cir. 1947)

Before PHILLIPS, BRATTON, and HUXMAN, Circuit Judges.

PHILLIPS, Circuit Judge.

The Commissioner assessed gift taxes against Hogle for the years 1936 to 1941, inclusive. On review, the Tax Court held there were no deficiencies in gift taxes for those years.

The question presented is whether or not annual earnings of two trusts, one known as the Copley Trust, and one known as the Three Trust, during the years in question, from trading in securities and commodities carried on by the trusts under Hogle's direction, amounted to gifts by Hogle to the trusts. These trusts were before this court in Hogle v. Commissioner, 10 Cir., 132 F.2d 66, and the facts with respect to such trusts are there fully set out.

The Copley Trust was created in 1922 by Hogle and his wife for the benefit of their three children. It consisted of a securities trading account to be managed and operated under Hogle's direction, the property accruing to the trust to be divided among the children on April 15, 1945. The trust was irrevocable and Hogle retained no right to alter or amend the trust instrument, or to change the beneficial interests. None of the principal or income could revest in Hogle. It provided that any losses resulting from trading in excess of the "profits and various income returns thereof" should be made good by Hogle, and that any such losses should not become an indebtedness of the trustee or the beneficiaries, but that any such losses made good by Hogle should be returned to him out of the first profits that accrued from further transactions.

On October 7, 1922, a margin account was opened for the trust with J. A. Hogle & Company, a brokerage partnership, consisting of Hogle and his wife, and in which the three children subsequently became partners. The trading resulted in profits in every year, except 1928 and 1929. In those years, certain securities were given to the trust by Hogle and his wife. The profits and benefits in the trust were divided on April 15, 1945, among the three children, and the trust was terminated.

In 1932, Hogle opened a trading account with the partnership in the name of the Three Trust account and a few days thereafter, Hogle and his wife created the Three Trust, consisting of a securities trading account for the benefit of the three children. The trust was irrevocable and was in all respects like the Copley

Trust, with the exception it was to terminate on April 15, 1950, and income could be distributed in the meantime in the discretion of Hogle and any two of the three trustees. Although the trading was conducted in the name of the trust, receipts and disbursements were credited and debited to the individual beneficiaries according to the specified share of each during the term of the trust. Gains and profits were realized in every year, including the taxable years.

The net worth of each trust in each of the years for which the gift taxes were assessed was more than sufficient to provide the margins required to cover the trading carried on for it.

In Hogle v. Commissioner, supra, we held, under the doctrine of Helvering v. Clifford, 309 U.S. 331, that the net income resulting from trading on margin was taxable to Hogle. We do not think it follows, however, that the net income in each of the taxable years derived from trading constituted a gift thereof by Hogle to the trusts.

Section [2501(a) imposes] a tax upon the transfer, during the calendar year, of property by gift. . . . And Treasury Regulations [§25.2511-1] provides among other things that a gift tax is imposed whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; and further, that the tax applies to all transactions whereby property or property rights or interests are donatively passed or conferred upon another. The purpose of the statute is to reach and lay a tax upon every type and kind of transfer of property by gift. With that legislative purpose in mind, the terms "property," "transfer," "gift," and "indirectly," as used in the statute, should be interpreted in their broadest and most comprehensive sense. But the tax cannot be sustained unless there was a transferor, a transferee, and an effective transfer of title or other economic interest or benefit in property having the quality of a gift.

The net income derived from trading carried on in behalf of the trusts accrued immediately and directly to the trusts, and did not consist of income accruing to Hogle which he transferred by anticipatory gift to the trusts. Hogle never owned or held an economic interest in such income. Likewise, since the funds in the trusts were sufficient to provide the margins required to cover the trading carried on in the taxable years, any losses resulting from trading would have been suffered immediately and directly by the trusts. What, in fact and in reality, Hogle gave to the trusts in the taxable years was his expert services in carrying on the trading, personal services in the management of the trusts. Hogle could give or withhold his personal services in carrying on trading on margin for the trusts. He could not withhold from the trusts any of the income accruing from trading on margin. How could he give what he could not withhold? There was no transfer directly or indirectly from Hogle to the trusts of title to, or other economic interest in, the income, from trading on margin, having the quality of a gift. In short there was no transfer directly or indirectly by Hogle to the trusts of property or property rights.

The Commissioner places strong reliance upon Hogle v. Commissioner, supra, to sustain the contention that the income arising from the trading on margin represented personal earnings of Hogle; and that Hogle in substance gave to the trusts the profits derived from part of his individual efforts. Certain excerpts from the opinion are emphasized in support of the argument that the net income arising from the trading on margin for the benefit of the trusts represented earnings of Hogle, and that, upon the accrual of such income to the trusts, a transfer having the quality of a gift was effectuated within the meaning of [§2501(a)]. But, we think a critical reading of the opinion in that case in its entirety will indicate that it does not support the Commissioner's contention. While the court

drew a distinction between the income tax liability of Hogle on profits accruing to the trusts from trading on margin and gains accruing to the trusts from other sources, and held that he was liable for the tax on net income derived from such trading but not on gains accruing from other sources, his liability for tax on the net income derived from trading on margin was predicated upon his power to control indirectly the extent of the profit derived from such trading by determining the extent and amount of such trading. Despite certain statements contained in the opinion on which the Commissioner relies, the basis of the holding that Hogle was liable for income tax on the net income resulting from trading on margin was his power to control the extent of such trading and therefore the extent of the income therefrom. It was predicated on his power to dominate the amount of income that would accrue from trading. That was the essence of our holding. We did not hold that such income accrued first to Hogle and was by him transferred by anticipatory gift to the trusts.

Our holding in Hogle v. Commissioner, supra, was an extreme application of the doctrine of the *Clifford* case, supra. To hold that the profits accruing from trading in margins constitute gifts from Hogle to the trusts, we think, would be an unjustified extension of the doctrine of the *Clifford* case.

Affirmed.

HUXMAN, Circuit Judge, concurs in the result.

NOTE

Gift of "services." Does *Hogle* rest on the ground that the taxpayer made a gift of his services, not of "property" within the meaning of §2501(a) (tax is imposed "on the transfer of property by gift")? Did the taxpayers in Lucas v. Earl (supra p. 343), G.C.M. 27026 (supra p. 344), and Teschner v. Commissioner (supra p. 346) make gifts of "property"?

SECTION D. TRANSFERS FOR CONSIDERATION AND/OR IN DISCHARGE OF LEGAL OBLIGATIONS

COMMISSIONER v. WEMYSS

324 U.S. 303 (1945)

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

In 1939 taxpayer proposed marriage to Mrs. More, a widow with one child. Her deceased husband had set up two trusts, one half the income of which was for the benefit of Mrs. More and the other half for that of the child with provision that, in the event of Mrs. More's remarriage, her part of the income ceased and went to the child. The corpus of the two trusts consisted of stock which brought to Mrs. More from the death of her first husband to her remarriage, about five years later, an average income of $5,484 a year. On Mrs. More's unwillingness to suffer loss of her trust income through remarriage the parties on May 24, 1939, entered upon an agreement whereby taxpayer transferred to Mrs. More a block of shares of stock. Within a month they married. The Commissioner ruled that the transfer of this stock, the value of which, $149,456.13, taxpayer does not controvert, was subject to the Federal Gift Tax. Accordingly, he assessed a deficiency which the Tax Court upheld, 2 T.C. 876, but the Circuit Court of Appeals reversed the Tax Court, 144 F.2d 78. We granted certiorari to settle uncertainties in tax administration engendered by seemingly conflicting decisions. 323 U.S. 703.

The answer to our problem turns on the proper application of [§§2501(a) and 2512(b)] to the immediate facts.

In view of the major role which the Tax Court plays in federal tax litigation,

it becomes important to consider how that court dealt with this problem. Fusing, as it were, [§§2501(a) and 2512(b)], the Tax Court read them as not being limited by any common law technical notions about "consideration." And so, while recognizing that marriage was of course a valuable consideration to support a contract, the Tax Court did not deem marriage to satisfy the requirement of [§2512(b)] in that it was not a consideration reducible to money value. Accordingly, the Court found the whole value of the stock transferred to Mrs. More taxable under the statute and the relevant Treas. Reg. [§25.2512-8]: "A consideration not reducible to a money value, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift." In the alternative, the Tax Court was of the view that if Mrs. More's loss of her trust income rather than the marriage was consideration for the taxpayer's transfer of his stock to her, he is not relieved from the tax because he did not receive any money's worth from Mrs. More's relinquishment of her trust income, and, in any event, the actual value of her interest in the trust, subject to fluctuations of its stock earnings, was not proved. One member of the Tax Court dissented, deeming that the gift tax legislation invoked ordinary contract conceptions of "consideration."

The Circuit Court of Appeals rejected this line of reasoning. It found in the marriage agreement an arm's length bargain and an absence of "donative intent" which it deemed essential: "A donative intent followed by a donative act is essential to constitute a gift; and no strained and artificial construction of a supplementary statute should be indulged to tax as a gift a transfer actually lacking donative intent." 144 F.2d 78, 82.

Sections [2501(a) and 2512(b)] are not disparate provisions. Congress directed them to the same purpose, and they should not be separated in application. Had Congress taxed "gifts" simpliciter, it would be appropriate to assume that the term was used in its colloquial sense, and a search for "donative intent" would be indicated. But Congress intended to use the term "gifts" in its broadest and most comprehensive sense. H. Rep. No. 708, 72nd Cong., 1st Sess., p. 27; S. Rep. No. 665, 72nd Cong., 1st Sess., p. 39; cf. Smith v. Shaughnessy, 318 U.S. 176; Robinette v. Helvering, 318 U.S. 184. Congress chose not to require an ascertainment of what too often is an elusive state of mind. For purposes of the gift tax it not only dispensed with the test of "donative intent." It formulated a much more workable external test, that where "property is transferred for less than an adequate and full consideration in money or money's worth," the excess in such money value "shall, for the purpose of the tax imposed by this title, be deemed a gift. . . ." And Treasury Regulations have emphasized that common law considerations were not embodied in the gift tax.[1]

To reinforce the evident desire of Congress to hit all the protean arrangements which the wit of man can devise that are not business transactions within the meaning of ordinary speech, the Treasury Regulations make clear that no genuine business transaction comes within the purport of the gift tax by excluding "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)." Treas. Reg. [§25.2512-8]. Thus on finding that a transfer in the circumstances of a particular case is not made in the ordinary course of business, the transfer becomes subject to the gift tax to the extent that it is not made "for an

[1] Treas. Reg. 79 (1936 Ed.) Art. 1 [now Regs. §25.2512-8]: "*Imposition of tax.* . . . The tax is not limited in its imposition to transfers of property without a valuable consideration, which at common law are treated as gifts, but extends to sales and exchanges for less than an adequate and full consideration in money or money's worth."

adequate and full consideration in money or money's worth." See 2 Paul, Federal Estate and Gift Taxation (1942) p. 1113.

The Tax Court in effect found the transfer of the stock to Mrs. More was not made at arm's length in the ordinary course of business. It noted that the inducement was marriage, took account of the discrepancy between what she got and what she gave up, and also of the benefit that her marriage settlement brought to her son. These were considerations the Tax Court could justifiably heed, and heeding, decide as it did. Its conclusion on the issue before it was no less to be respected than were the issues which we deemed it was entitled to decide as it did in Dobson v. Commissioner, 320 U.S. 489, Commissioner v. Heininger, 320 U.S. 467, Commissioner v. Scottish American Co., 323 U.S. 119.

If we are to isolate as an independently reviewable question of law the view of the Tax Court that money consideration must benefit the donor to relieve a transfer by him from being a gift, we think the Tax Court was correct. See Commissioner v. Bristol, 121 F.2d 129. To be sure, the Revenue Act of 1932 does not spell out a requirement of benefit to the transferor to afford relief from the gift tax. Its forerunner, §320 of the 1924 Act, was more explicit in that it provided that the excess of the transfer over "the consideration received shall . . . be deemed a gift." It will hardly be suggested, however, that in re-imposing the gift tax in 1932 Congress meant to exclude transfers that would have been taxed under the 1924 Act. The section [§2512(b)] taxing as gifts transfers that are not made for "adequate and full [money] consideration" aims to reach those transfers which are withdrawn from the donor's estate. To allow detriment to the donee to satisfy the requirement of "adequate and full consideration" would violate the purpose of the statute and open wide the door for evasion of the gift tax. See 2 Paul, supra, at 1114.

Reversed.

MR. JUSTICE ROBERTS dissents, and would affirm the judgment for the reasons given in the opinion of the Circuit Court of Appeals.

MERRILL v. FAHS

324 U.S. 308 (1945)

MR. JUSTICE FRANKFURTER delivered the opinion of the Court.

This is a companion case to Commissioner v. Wemyss.

On March 7, 1939, taxpayer, the petitioner, made an antenuptial agreement with Kinta Desmare. Taxpayer, a resident of Florida, had been twice married and had three children and two grandchildren. He was a man of large resources, with cash and securities worth more than $5,000,000, and Florida real estate valued at $135,000. Miss Desmare's assets were negligible. By the arrangement entered into the day before their marriage, taxpayer agreed to set up within ninety days after marriage an irrevocable trust for $300,000, the provisions of which were to conform to Miss Desmare's wishes. The taxpayer was also to provide in his will for two additional trusts, one, likewise in the amount of $300,000, to contain the same limitations as the inter vivos trust, and the other, also in the amount of $300,000, for the benefit of their surviving children. In return Miss Desmare released all rights that she might acquire as wife or widow in taxpayer's property, both real and personal, excepting the right to maintenance and support. The inducements for this agreement were stated to be the contemplated marriage, desire to make fair requital for the release of marital rights, freedom for the taxpayer to make appropriate provisions for his children and other dependents, the uncertainty surrounding his financial future and marital tranquillity. That such

an antenuptial agreement is enforceable in Florida is not disputed, . . . nor that Florida gives a wife an inchoate interest in all the husband's property contingent during his life but absolute upon death. . . . The parties married, and the agreement was fully carried out.

On their gift tax return for 1939, both reported the creation of the trust but claimed that no tax was due. The Commissioner, however, determined a deficiency of $99,000 in taxpayer's return in relation to the transfer of the $300,000. Upon the Commissioner's rejection of the taxpayer's claim for refund of the assessment paid by him, the present suit against the Collector was filed. The District Court sustained the taxpayer, 51 F. Supp. 120, but was reversed by the Circuit Court of Appeals for the Fifth Circuit, one judge dissenting. 142 F.2d 651. We granted certiorari in connection with Commissioner v. Wemyss, supra, and heard the two cases together. 323 U.S. 686.

This case, unlike the *Wemyss* case, does not come here by way of the Tax Court. No aid can therefore be drawn from a prior determination by the tribunal specially entrusted with tax adjudications. (See Griswold, The Need for a Court of Tax Appeals (1944) 57 Harv. L. Rev. 1153, 1173.) But like the *Wemyss* case, this case turns on the proper application of [§2512(b)]. Taxpayer claims that Miss Desmare's relinquishment of her marital rights constituted "adequate and full consideration in money or money's worth." The Collector, relying on the construction of a like phrase in the estate tax, contends that release of marital rights does not furnish such "adequate and full consideration."

We put to one side the argument that in any event Miss Desmare's contingent interest in her husband's property had too many variables to be reducible to dollars and cents, and that any attempt to translate it into "money's worth" was "mere speculation bearing the delusive appearance of accuracy." Humes v. United States, 276 U.S. 487, 494. We shall go at once to the main issue.

The guiding light is what was said in Estate of Sanford v. Commissioner, 308 U.S. 39, 44: "The gift tax was supplementary to the estate tax. The two are in pari materia and must be construed together." The phrase on the meaning of which decision must largely turn — that is, transfers for other than "an adequate and full consideration in money or money's worth" — came into the gift tax by way of estate tax provisions. It first appeared in the Revenue Act of 1926. Section 303(a)(1) of that Act allowed deductions from the value of the gross estate of claims against the estate to the extent that they were bona fide and incurred "for an adequate and full consideration in money or money's worth." [§2053(c)(1)(A).] It is important to note that the language of previous Acts which made the test "fair consideration" was thus changed after courts had given "fair consideration" an expansive construction.

The first modern estate tax law included in the gross estate transfers in contemplation of, or intended to take effect in possession or enjoyment at, death, except "a bona fide sale for a fair consideration in money or money's worth." §202(b), Revenue Act of 1916. Dower rights and other marital property rights were intended to be included in the gross estate, since they were considered merely an expectation, and in 1918 Congress specifically included them. §402(b), Revenue Act of 1918. This provision was for the purpose of clarifying the existing law. H. Rep. No. 767, 65th Cong., 2d Sess., p. 21. In 1924 Congress limited deductible claims against an estate to those supported by "a fair consideration in money or money's worth," §303(a)(1), Revenue Act of 1924, employing the same standard applied to transfers in contemplation of death, H. Rep. No. 179, 68th Cong., 1st Sess., pp. 28, 66. Similar language was used in the gift tax, first imposed by the 1924 Act, providing, "Where property is sold or exchanged for less than a fair consideration in money or money's worth" the excess shall be deemed a gift.

The two types of tax thus followed a similar course, like problems and purposes being expressed in like language. In this situation, courts held that "fair consideration" included relinquishment of dower rights. Ferguson v. Dickson, 300 F. 961; and see McCaughn v. Carver, 19 F.2d 126; Stubblefield v. United States, 6 F. Supp. 440. Congress was thus led, as we have indicated, to substitute in the 1926 Revenue Act, the words "adequate and full consideration" in order to narrow the scope of tax exemptions. See Taft v. Commissioner, 304 U.S. 351, 356. When the gift tax was re-enacted in the 1932 Revenue Act, the restrictive phrase "adequate and full consideration" as found in the estate tax was taken over by the draftsman.

To be sure, in the 1932 Act Congress specifically provided that relinquishment of marital rights for purposes of the estate tax shall not constitute "consideration in money or money's worth." [§2043(b).] The Committees of Congress reported that if the value of relinquished marital interests "may, in whole or in part, constitute a consideration for an otherwise taxable transfer (as has been held to be so), or an otherwise unallowable deduction from the gross estate, the effect produced amounts to a subversion of the legislative intent. . . ." H. Rep. No. 708, 72d Cong., 1st Sess., p. 47; S. Rep. No. 665, 72d Cong., 1st Sess., p. 50. Plainly, the explicitness was one of cautious redundancy to prevent "subversion of the legislative intent." Without this specific provision, Congress undoubtedly intended the requirement of "adequate and full consideration" to exclude relinquishment of dower and other marital rights with respect to the estate tax. Commissioner v. Bristol, 121 F.2d 129; Sheets v. Commissioner, 95 F.2d 727.

We believe that there is every reason for giving the same words in the gift tax the same reading. Correlation of the gift tax and the estate tax still requires legislative intervention. Commissioner v. Prouty, 115 F.2d 331, 337; Warren, Correlation of Gift and Estate Taxes (1941) 55 Harv. L. Rev. 1; Griswold, A Plan for the Coordination of the Income, Estate and Gift Tax Provisions (1942) 56 Harv. L. Rev. 337. But to interpret the same phrases in the two taxes concerning the same subject matter in different ways where obvious reasons do not compel divergent treatment is to introduce another and needlesss complexity into this already irksome situation. Here strong reasons urge identical construction. To hold otherwise would encourage tax avoidance. Commissioner v. Bristol, supra at 136; 2 Paul, Estate and Gift Taxation (1942) p. 1118. And it would not fulfill the purpose of the gift tax in discouraging family settlements so as to avoid high income surtaxes. H. Rep. No. 708, 72d Cong., 1st Sess., p. 28; S. Rep. No. 665, 72d Cong., 1st Sess., p. 40. There is thus every reason in this case to construe the provisions of both taxes harmoniously. Estate of Sanford v. Commissioner, supra.[1]

Affirmed.

MR. JUSTICE ROBERTS dissents.

MR. JUSTICE REED, dissenting.

This case differs from Commissioner v. Wemyss, ante, p. 303. Whether the transferor of the sums paid for the release of dower and other marital rights, received adequate and full consideration in money and money's worth is a question of fact. The agreement recites that the parties contemplate marriage and provides that the trust shall be set up only in the event of and following the marriage. Petitioner was obligated to create the trust upon consideration of the relinquishment of marital rights and did so, and hence this is not a case involving marriage alone as consideration. Through the tables of mortality, the value of

[1] Treasury Regulations [§25.2512-8] is inapplicable. To find that the transaction was "made in the ordinary course of business" is to attribute to the Treasury a strange use of English.

a survivor's right in a fixed sum receivable at the death of the second party may be adequately calculated. By adopting present value as the accepted future value, the uncertainty inherent in fluctuations of an estate's value is theoretically eliminated. The trial court thus found the present value of the release of the taxpayer's estate from the wife's survivorship rights largely exceeded the amount paid by the taxpayer and that the transactions between the parties were made in good faith for business reasons and not an attempt to evade or avoid taxes. Thus the District Court findings bring this transaction within the express language of the applicable Treasury Regulation [§25.2512-8, relating to transfers in the ordinary course of business]. Its determination, we think, also makes it clear that the husband's estate received practical advantages of value in excess of the cost paid. See Henderson v. Usher, 125 Fla. 709, 727, 170 So. 846.

The question of the taxability as gifts of transfers to spouses in consideration of the release of marital rights had been a matter of dispute in courts before the passage of the Revenue Act of 1932. . . . It seems to us clear that with the judicial history of the difficulties in estate and gifts taxes as to the transfer of marital rights, when Congress expressly provided [in 1932] that relinquishment of dower, curtesy or other statutory estate was not "consideration" for estate tax purposes and left the gift tax provision without such a limitation, it intended that these rights be accorded a different treatment under these sections. . . .

In our views this judgment should be reversed.

The CHIEF JUSTICE and MR. JUSTICE DOUGLAS join in this dissent.

NOTE

1. *Antenuptial settlements.* Was the value of the prospective Mrs. Merrill's right to dower more conjectural than the dissenting justices acknowledge? The district judge's calculation is found in 51 F. Supp. at 120 and is criticized by the Court of Appeals in 142 F.2d at 651.

2. *Income tax aspects.* The relation of antenuptial settlements to income taxation is discussed in Farid-Es-Sultaneh v. Commissioner, supra page 133. Does it follow from that case that Mr. Kresge realized income in 1923 and 1924, because he exchanged the stock for the release of dower, to the extent of the difference between (a) his cost basis for the shares and (b) their value (or the value of the released rights) at the time of the transfer? Should he have paid both an income tax and a gift tax on the transfer?

3. *Freedom as consideration under §2512(b).* Shelton v. Lockhart, 154 F. Supp. 244 (W.D. Mo. 1957), concerned liability for gift tax under the following circumstances: An Osage Indian Princess applied to the Bureau of Indian Affairs for a "certificate of competency" so that property being administered for her by the Bureau could be transferred to her and so that she would be freed from other restrictions imposed on certain Indians. As a condition to granting the certificate, the Bureau required her to transfer $200,000 of the property to be released to her into an irrevocable trust for the benefit of her children. Holding that no gift tax was due, the court suggested that the transfer might be regarded as made for adequate and full consideration under §2512(b), i.e., freedom from the restrictions of the Bureau of Indian Affairs, but that in any event it was part of a business transaction.

COMMISSIONER v. GREENE

119 F.2d 238 (9th Cir. 1941), cert. denied, 314 U.S. 641 (1941)

Before GARRECHT, HANEY, and STEPHENS, Circuit Judges.

HANEY, Circuit Judge.

The Commissioner of Internal Revenue petitions us to review decisions of the Board of Tax Appeals that there were no deficiencies in the taxpayer's gift tax for the years 1936 and 1937.

Alice H. Lester and W. E. Lester were married more than forty years ago. As a result of the marriage two daughters, Carolyn and Beatrice, were born. The former is now about 47 years old, and the latter about 43. More than 30 years ago Alice H. Lester became incompetent and ever since has been and is now confined in an institution for insane persons. Prior thereto, the husband, wife and two daughters lived together as a family unit in luxury and in the manner of people of wealth. After the incompetency of the wife, the husband and two daughters lived together as a family unit until the marriage of Carolyn, and thereafter, the husband and Beatrice continued to live as a family unit until the marriage of Beatrice. Carolyn first married one Hamilton, and in 1930 married Thomas J. Loan who is now her husband. Beatrice in 1932 married one Pauli from whom she was divorced in 1938 and has since been unmarried.

The husband of Alice H. Lester died on May 29, 1933, and left an estate appraised at about $38,000 which was distributed in equal shares to the two daughters and the estate of the incompetent.

The incompetent has always been a person of large financial means. For example, the income from the principal of her estate which is in excess of $2,000,000 was: for 1932 — $121,931; for 1933 — $91,473.85; for 1934 — $88,385.74; for 1935 — $68,468.91; for 1936 — $109,673.53; and for 1937 — $142,614.13.

Loan has never contributed to the support of Carolyn, and Pauli has never contributed to the support of Beatrice. Both daughters were from birth accustomed to a life of ease and luxury, and neither of them was trained for any gainful occupation and neither of them was during any of said times able to engage in any gainful occupation. Since the incompetency of their mother, the only means of support available to them has been the incompetent's estate. Except to the extent of their interest, if any, in the incompetent's estate, the payments received therefrom, and the distributions received from their father's estate, both daughters have been at all times since prior to June 6, 1932, poor persons unable to maintain themselves by work.

From time to time since the inception of the incompetency of the mother, the proper state court has made orders directing the payment of money from the estate to the husband and the two daughters. Prior to the calendar year 1937, such court refused to direct payments except for the maintenance and support of the father and daughters. The amounts ordered to be paid were liberal. Such payments were apparently made pursuant to the following provisions of the California Civil Code and Probate Code, respectively:

> §206. . . . It is the duty of the father, the mother, and the children of any poor person who is unable to maintain himself by work, to maintain such person to the extent of their ability. . . .
>
> §1502. . . . Every guardian of an estate must manage it frugally and without waste, and apply the income, as far as may be necessary, to the comfortable and suitable support, maintenance and education of the ward and his family, if any. . . .

On October 19, 1937, the state court ordered that additional payments be made to the two daughters pursuant to Calif. Probate Code, §1558, as follows:

> On the application of the guardian or next of kin of an insane or incompetent person, the court may direct the guardian to pay and distribute surplus income, not used for the support and maintenance of the ward, or any part of such surplus income, to the next of kin whom the ward would, in the judgment of the court, have aided, if said ward had been of sound mind. The granting of such allowance and the amounts and proportions thereof shall be discretionary with the court, but the court shall give consideration to the amount of surplus income available after due provision has been made for the proper support and maintenance of the ward, to the circumstances and condition of life to which the ward and said next of kin have been accustomed and to the amount

which the ward would, in the judgment of the court, have allowed said next of kin, had said ward been of sound mind. . . .

In the order the court directed that $7,500 be paid to each daughter and found: "That in the judgment of the court, due consideration being given to the amount of said surplus income, the circumstances and condition of life to which said ward and her said children have been accustomed, said ward, if she were of sound mind, would aid said children and would pay and distribute to her said children the portion of the said surplus income which is hereinafter directed to be so distributed."

The $7,500 was in addition to the amounts ordered to be paid for maintenance of the daughters. . . .

Respondent's argument is that Calif. Probate Code, §1502, and Calif. Civil Code, §206, impose obligations upon the incompetent's estate to support the daughters; that the state court's orders were binding on that question; and that the payments were made without donative intent and were not, therefore, gifts. Respondent's argument is based on the theory that state law is applicable. The first question to be decided is whether the state law is applicable.

The rule is that "State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law." Burnet v. Harmel, 287 U.S. 103, 110. [The court also cited and discussed United States v. Pelzer, infra page 1053, holding that the term "future interests" as used in §2503(b), 1954 Code, was to be defined by federal, rather than state, standards.]

Here, property, i.e., money, was transferred, and pursuant to [§2512(b)], the amount of the gift is "the amount by which the value of the property exceeded the value of the consideration." The only thing in question here is the "consideration." Nothing in the act expressly states that the existence of consideration is to be determined by state law. There is no more reason for saying here that Congress meant consideration as defined by state law, than there was for saying the Congress meant "future interests" as defined by state law.

The committee reports state that the tax imposed by the act "is designed to reach all transfers to the extent that they are donative, and to exclude any consideration not reducible to money or money's worth . . ." Treasury Regulations [§25.2512-8] provides in part: "Transfers reached by the gift tax are not confined to those only which, being without a valuable consideration, accord with the common law concept of gifts. . . . A consideration not reducible to a money value, as love and affection, promise of marriage, etc., is to be wholly disregarded, and the entire value of the property transferred constitutes the amount of the gift."

It is thus apparent that there is nothing to indicate that local law was to determine what might be consideration, but on the contrary, the taxing act considered certain transfers as gifts, whether local law so considered them or not. Since local law is not controlling, it is immaterial what local statutes said, or local courts held. . . .

Respondent's contention that there was no donative intention is immaterial, because [§2512(b)] of the act in question does not require it.

The Board's decisions are reversed and the cause is remanded to the Board for further proceedings in accordance with the views herein expressed.

STEPHENS, Circuit Judge.

I dissent.

The majority opinion holds that all moneys paid out of the incompetent's estate for the support of her adult married daughters are "gifts" and taxable as such.

and holds as immaterial the legal fact that the California Code imposed a legal duty upon her to support her indigent children. This is based upon the theory that "State law may control only when the federal taxing act, by express language or necessary implication, makes its own operation dependent upon state law," citing the recent case of United States v. Pelzer [infra page 1053].

I do not read the *Pelzer* case as authority for the proposition that we are not bound by the State law in the instant case. There the question involved was whether or not the gift under consideration was a gift of a "future interest." It was argued by the taxpayer that the Federal courts were bound by the State law defining what constituted a "future interest." The Supreme Court looked to the committee reports and determined that the purpose of the statute was to make taxable gifts "whether vested or contingent, limited to commence in possession or enjoyment at a future date," and that this was what was meant by the words "future interest" in the taxing statute. The Regulations had defined "future interest" in the same terms. The Court merely held that the provisions of the taxing statute were not subject to state control in this respect.

In the instant case the committee reports state that the tax imposed by the Act "is designed to reach all transfers to the extent that they are donative, and to exclude any consideration not reducible to money or money's worth. . . ." The Regulations promulgated under the Act provide that the tax shall apply to transfers without consideration, and that "a consideration not reducible to a money value, as love and affection, promise of marriage, etc., is to be wholly disregarded."

But this is not to say that a transfer in discharge of a legal obligation imposed by local law is a transfer without consideration under the taxing act. It is my opinion that the discharge of a legal obligation is clearly "consideration" within the meaning of the tax act, and that the statute by necessary implication makes its own operation in that respect dependent upon State law.

It seems clear that under California Civil Code, Section 206, and the cases construing that section, the incompetent at all times material to this controversy was subject to a legally enforceable obligation to support and maintain her daughters, who were, as pointed out by the majority, "poor persons unable to maintain themselves by work" within the meaning of the California law. Section 206 fixes the obligation as "to the extent of [her] ability." Section 1502 of the California Probate Code provides for the support of the family of an incompetent by the application of the income "as far as may be necessary, to the comfortable and suitable support, maintenance and education" of the family. The measure of the support and maintenance allowance was a matter for the discretion of the California Superior Court, sitting in probate, and its determination that the amounts distributed to the incompetent's daughters were necessary for their comfortable and suitable maintenance is binding upon us.

The decision of the Board should be affirmed.

E.T. 19

1946-2 C.B. 166

Advice has been requested concerning the application of the gift tax to transfers made pursuant to an agreement of the parties incident to a proceeding for divorce or legal separation. . . .

In Commissioner v. Wemyss (1945) (324 U.S., 303), the Supreme Court upheld the decision of the Tax Court to the effect that an antenuptial transfer of stock to a prospective bride, a widow, was subject to the gift tax where made pursuant to an agreement to compensate her for the loss of trust income that she would

suffer on remarriage. The Supreme Court approved the reasoning of the Tax Court (a) that marriage was not a consideration reducible to a money value, and (b) that the controlling test is the receipt by the donor of money or money's worth, and not the loss of income or other rights by the donee. . . .

In Merrill v. Fahs (1945) (324 U.S., 308), the taxpayer transferred $300,000 in trust for his prospective bride in consideration of her release of all rights in his assets. The collector in support of his contention that the transfer was a gift relied on the restriction of the phrase "adequate and full consideration in money or money's worth" imposed by [§2043(b)] relating to the estate tax, which provides as follows:

> For the purposes of this chapter, a relinquishment or promised relinquishment of dower, curtesy, or of a statutory estate created in lieu of dower or curtesy, or of other marital rights in the decedent's property or estate, shall not be considered to any extent a consideration "in money or money's worth."

The Supreme Court in holding that the transfer was subject to the gift tax found that Congress intended that the "consideration" or "relinquishment" provision in the estate tax law also applies to the gift tax. . . .

Some indication of the Congressional intent with respect to the above-quoted "relinquishment" clause, which was added to the Internal Revenue Code by the 1932 Revenue Act, is disclosed in the report of the Ways and Means Committee (C.B. 1939-1 (Part 2), 491), reading in part as follows:

> This amendment excludes, in determining "consideration in money or money's worth," the value of a relinquished, or a promised relinquishment of, dower, curtesy, or other marital rights in decedent's property. Section 302(a) and (b) of the 1926 Act require the value of such an interest to be included in the gross estate, and, if its value may, in whole or in part, constitute a consideration for an otherwise taxable transfer (as has been held to be so), or an otherwise unallowable deduction from the gross estate, the effect produced amounts to a subversion of the legislative intent expressed in section 302(a) and (b).
>
> For example, a decedent dies leaving an estate of $1,500,000 (after payment of all charges), and under the State law the surviving spouse is entitled to one-third, or $500,000, of which she can not be deprived by will without her consent. Under existing law, the estate is entitled to no deduction on account of her statutory rights, but, if she and decedent had entered into a contract by which she was to receive from his estate a stated sum in consideration of a waiver of her statutory rights, the amount due her under the contract might be held a deductible claim against the estate as having been contracted for an adequate and full consideration in money's worth, namely, the value of her waived marital rights.

The gift tax is supplementary to the estate tax. It taxes, to a large extent, transfers inter vivos which deplete the estate that the donor would otherwise leave at death. Taxability, therefore, under the gift tax of other than commercial transactions is said to be determined by, and to the extent of, absence of financial benefit to the transferor. (Commissioner v. Wemyss, supra; [§2512(b)]).

Under a decree of divorce or legal separation a husband's duty to support a divorced wife (alimony) customarily lasts only during the joint lives of the parties or until the divorced wife remarries. (Vernier, "American Family Laws," Volume II, 1932 and Supp. 1938.) The fulfillment, therefore, of this obligation by the husband merely amounts to the liquidation of a presently existing obligation, the satisfaction of which does not have the effect of diminishing or depleting the husband's estate to any greater extent than the payment of other existing legal obligations. On the other hand, a transfer to a wife under such a decree in settlement of inheritance rights is a present transfer of what would otherwise constitute a major portion of the husband's estate on death.

The construction spelled out in [§2043(b)], supra, governs the interpretation of the phrase "adequate and full consideration in money or money's worth" as that phrase is used in [§2512(b)] of the Internal Revenue Code. (Merrill v. Fahs, supra.) The consideration for a transfer by way of property settlement other than relinquishment by the wife of her right to support and maintenance is the relinquishment by the wife of her marital rights in the husband's property or estate and falls squarely within the statutory provisions. Section [2043(b)], however, makes no specific reference to support rights. It is the view of the Bureau that the surrender of support rights is not one of the "other marital rights" referred to in the section. The cases of Meyer's Estate v. Helvering (C.C.A. 2, 1940) (110 Fed. (2d), 367, certiorari denied, 310 U.S., 651) and Helvering v. United States Trust Co. et al. (C.C.A. 2, 1940) (111 Fed. (2d), 576) will no longer be followed to the extent that they hold that the right of a divorced wife to support from a former husband during the joint lives of the parties is a marital right in his property or estate.

With respect to transfers made pursuant to legal separation agreements or divorce decrees, it is the position of the Bureau that, for both estate and gift tax purposes, a release of support rights may constitute a consideration in money or money's worth. Accordingly, to the extent that a transfer does not exceed the reasonable value of the support right of the wife it is to be treated as made for an adequate and full consideration in money or money's worth. The question whether the transfer is in excess of reasonable support rights is for the determination of the Bureau. That portion of any transfer which is allocable to the release by the wife of her property or inheritance rights is to be considered as not made "to any extent" for an adequate and full consideration in money or money's worth.*

The establishment of a reasonable allocation is regarded as a proper matter for administrative determination by the Bureau in the absence of a reasonable allocation or segregation by the parties. In making this determination the facts and circumstances of each case will be separately considered. Elements to be considered are the amount of the husband's annual income, the extent of his assets, also, the life expectancies of the parties and the probability of the wife's remarriage, alimony almost universally being limited to such periods. An agreement of the parties may provide for payments extending beyond the period of their joint lives. The required allocation in such a case will involve a determination of the question whether the aggregate amounts paid and payable exceed normal support rights, which ordinarily would terminate upon the death of the husband. The contingency of the wife's remarriage may be measured by actuarial standards. . . .

NOTE

1. *Payments in discharge of support obligations.* E.T. 19 is concerned with transfers under agreements incident to proceedings for divorce or legal separation; presumably the proposition that one does not incur a gift tax liability by supporting his wife or children in an amicable family setting was thought so obvious as not to require an explicit statement. In the case of a united family, however, do amounts paid for support escape the gift tax only to the extent that they constitute "the liquidation of a presently existing obligation" (to use the criterion of E.T. 19) — so that a gift tax is due if the family is maintained at a level above the husband's legal obligation and, a fortiori, if they live beyond their means? Is the cost of food, clothing, and shelter exempt no matter

* This part of E.T. 19 was subsequently modified, as a result of Harris v. Commissioner, infra page 1036. See Rev. Rul. 60-160, 1960-1 C.B. 374. — Ed.

how luxurious? What about jewelry, fur coats, vacation trips, education, and the use of summer homes and yachts?

The $3000 annual per-donee exclusion was enacted to make it unnecessary to report small gifts, as well as wedding and Christmas gifts. S. Rept. No. 665, 72d Cong., 1st Sess., reprinted in 1939-1 C.B. (Part 2) 496, 524. Does this imply that wedding, birthday, and Christmas gifts to the donor's spouse and minor children are taxable gifts (to the extent they exceed the exclusion) or can a station-in-life concept of support be invoked to avoid a gift tax if the gift (e.g., a Jaguar, chinchilla wrap, or diamond brooch) is no more than is expected in the donor's environment?

Does E.T. 19 relinquish gift tax liability if the transfer discharges a support obligation under local law, no matter how far it may enlarge the concept of "support"? In a number of jurisdictions, a parent is legally required to support an incompetent adult child, either by statute or by the common law. See Annotation, Parent's Obligation to Support Adult Child, 1 A.L.R.2d 910. What if the parent's duty were expanded to include a college and professional education for an adult child? An obligation to support him (and his wife and children, if any) while he gets established in his occupation and until he is self-supporting?

For some income tax aspects of "support," see page 338 supra (dependency exemption) and page 371 supra (support trusts); for the estate tax aspects, see page 1188 infra.

2. *Relation of support obligation to Holtz's Estate v. Commissioner.* Could the result in E.T. 19 have been reached via the route traversed in Holtz's Estate v. Commissioner: no gift where the transferred property is to be used to benefit the transferor? If, under local law, the obligation to support one's wife or children is diminished to the extent that they have independent resources, would the reasoning of *Holtz's Estate* relieve the settlor of gift tax liability on a trust under which the income was to go to his wife or children, even though it was not explicitly earmarked for support?

3. *Implications of reference to "property" in §2501(a).* Since the gift tax is imposed on the transfer of "property" by gift, §2501(a), is the use of the taxpayer's facilities (his residence, hotel suite, yacht, etc.) tax-free even if it exceeds his legal obligation of support? Even if the guest is someone whom he is not required to support, like a collateral relative or friend? Is there a distinction between (a) allowing a collateral relative or friend to occupy one's residence, (b) paying his rent or buying a residence for him to occupy, and (c) giving him money to enable him to buy or rent a place of his own? Does a father make a taxable gift by paying his son's law school tuition, setting him up in business, or taking him on a trip around the world, if such expenditures are beyond his legal obligation to support the son? Does the answer depend on whether he would be willing to give the son the same amount in cash without earmarking it for a special purpose? On whether the father is bribing the son to do something distasteful to him, or simply responding to the son's suggestion?

4. *Payment of wife's income tax liability.* If husband and wife file a joint income tax, their liability for the tax is joint and several (supra p. 335). According to Regs. §25.2511-1(d), the payment of the entire liability by one spouse is not a transfer for gift tax purposes. Why not, at least when the entire liability is paid by a spouse who earned only part of the income?

5. *Transfers by third persons.* If John Jones, Sr., establishes a trust for the support of John Jones, III, has he made a gift to John Jones, III, or to John Jones, Jr., whose duty to support the ostensible beneficiary of the trust may be reduced by the donor's generosity? Is there any need to identify the donee in order to compute the donor's tax liability?

6. *Reference.* Note, Federal Tax Aspects of the Obligation to Support, 74 Harv. L. Rev. 1191, 1213-1217 (1961).

HARRIS v. COMMISSIONER

340 U.S. 106 (1950)

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

The federal estate tax and the federal gift tax, as held in a line of cases ending with Commissioner v. Wemyss, 324 U.S. 303, and Merrill v. Fahs, 324 U.S. 308,

are construed in pari materia, since the purpose of the gift tax is to complement the estate tax by preventing tax-free depletion of the transferor's estate during his lifetime. Both the gift tax [§2512(b)] and the estate tax [§2053(c)(1)(A)] exclude transfers made for "an adequate and full consideration in money or money's worth." In the estate tax this requirement is limited to deductions for claims based upon "a promise or agreement"; but the consideration for the "promise or agreement" may not be the release of marital rights in the decedent's property [§2043(b)]. In the *Wemyss* and *Merrill* cases the question was whether the gift tax was applicable to premarital property settlements. If the standards of the estate tax were to be applied ex proprio vigore in gift tax cases, those transfers would be taxable because there was a "promise or agreement" touching marital rights in property. We sustained the tax, thus giving "adequate and full consideration in money or money's worth" the same meaning under both statutes insofar as premarital property settlements or agreements are concerned.

The present case raises the question whether *Wemyss* and *Merrill* require the imposition of the gift tax in the type of post-nuptial settlement of property rights involved here.

Petitioner divorced her husband, Reginald Wright, in Nevada in 1943. Both she and her husband had substantial property interests. They reached an understanding as respects the unscrambling of those interests, the settlement of all litigated claims to the separate properties, the assumption of obligations, and the transfer of properties.

Wright received from petitioner the creation of a trust for his lifetime of the income from her remainder interest in a then existing trust; an assumption by her of an indebtedness of his of $47,650; and her promise to pay him $416.66 a month for ten years.

Petitioner received from Wright 21/90 of certain real property in controversy; a discontinuance of a partition suit then pending; an indemnification from and assumption by him of all liability on a bond and mortgage on certain real property in London, England; and an indemnification against liability in connection with certain real property in the agreement. It was found that the value of the property transferred to Wright exceeded that received by petitioner by $107,150. The Commissioner assessed a gift tax on the theory that any rights which Wright might have given up by entering into the agreement could not be adequate and full consideration.

If the parties had without more gone ahead and voluntarily unravelled their business interests on the basis of this compromise, there would be no question but what the gift tax would be payable. For there would have been a "promise or agreement" that effected a relinquishment of marital rights in property. It therefore would fall under the ban of the provision of the estate tax which by judicial construction has been incorporated into the gift tax statue.

But the parties did not simply undertake a voluntary contractual division of their property interests. They were faced with the fact that Nevada law not only authorized but instructed the divorce court to decree a just and equitable disposition of both the community and the separate property of the parties.[1] The agreement recited that it was executed in order to effect a settlement of the respective property rights of the parties "in the event a divorce should be de-

[1] At the time of the divorce Nevada Compiled Laws, §9463 provided: "In granting a divorce the court may award such alimony to the wife and shall make such a disposition of the community and separate property of the parties as shall appear just and equitable, having regard to the respective merits of the parties and to the condition in which they will be left by such divorce, and to the party through whom the property was acquired, and to the burdens, if any, imposed upon it for the benefit of the children. . . ."

creed"; and it provided that the agreement should be submitted to the divorce court "for its approval." It went on to say, "It is of the essence of this agreement that the settlement herein provided for shall not become operative in any manner nor shall any of the recitals or covenants herein become binding upon either party unless a decree of absolute divorce between the parties shall be entered in the pending Nevada action."

If the agreement had stopped there and were in fact submitted to the court, it is clear that the gift tax would not be applicable. That arrangement would not be a "promise or agreement" in the statutory sense. It would be wholly conditional upon the entry of the decree; the divorce court might or might not accept the provisions of the arrangement as the measure of the respective obligations; it might indeed add to or subtract from them. The decree, not the arrangement submitted to the court, would fix the rights and obligations of the parties. That was the theory of Commissioner v. Maresi, 156 F.2d 929, and we think it sound.

Even the Commissioner concedes that that result would be correct in case the property settlement was litigated in the divorce action. That was what happened in Commissioner v. Converse, 163 F.2d 131, where the divorce court decreed a lump sum award in lieu of monthly payments provided by the separation agreement. Yet without the decree there would be no enforceable, existing agreement whether the settlement was litigated or unlitigated. Both require the approval of the court before an obligation arises. The happenstance that the divorce court might approve the entire settlement, or modify it in unsubstantial details, or work out material changes seems to us unimportant. In each case it is the decree that creates the rights and the duties; and a decree is not a "promise or agreement" in any sense — popular or statutory.

But the present case is distinguished by reason of a further provision in the undertaking and in the decree. The former provided that "the covenants in this agreement shall survive any decree of divorce which may be entered." And the decree stated "It is ordered that said agreement and said trust agreements forming a part thereof shall survive this decreee." The Court of Appeals turned the case on those provisions. It concluded that since there were two sanctions for the payments and transfers — contempt under the divorce decree and execution under the contract — they were founded not only on the decree but upon both the decree and a "promise or agreement." It therefore held the excess of the value of the property which petitioner gave her husband over what he gave her to be taxable as a gift. 178 F.2d 861.

We, however, think that the gift tax statute is concerned with the source of rights, not with the manner in which rights at some distant time may be enforced. Remedies for enforcement will vary from state to state. It is "the transfer" of the property with which the gift tax statute is concerned, not the sanctions which the law supplies to enforce transfers. If "the transfer" of marital rights in property is effected by the parties, it is pursuant to a "promise or agreement" in the meaning of the statute. If "the transfer" is effected by court decree, no "promise or agreement" of the parties is the operative fact. In no realistic sense is a court decree a "promise or agreement" between the parties to a litigation. If finer, more legalistic lines are to be drawn, Congress must do it.

If, as we hold, the case is free from any "promise or agreement" concerning marital rights in property, it presents no remaining problems of difficulty. The Treasury Regulations [§25.2512-8] recognize as tax free "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from donative intent)." This transaction is not "in the ordinary course of business" in any conventional sense. Few

transactions between husband and wife ever would be; and those under the aegis of a divorce court are not. But if two partners on dissolution of the firm entered into a transaction of this character or if chancery did it for them, there would seem to be no doubt that the unscrambling of the business interests would satisfy the spirit of the Regulations. No reason is apparent why husband and wife should be under a heavier handicap absent a statute which brings all marital property settlements under the gift tax. . . .

Reversed.

MR. JUSTICE FRANKFURTER, whom MR. JUSTICE BLACK, MR. JUSTICE BURTON, and MR. JUSTICE MINTON join, dissenting.

Section [§2512(b)] imposes a gift tax on property "transferred for less than an adequate and full consideration in money or money's worth." In Merrill v. Fahs, 324 U.S. 308, the Court held that an antenuptial settlement is subject to this tax. Believing as I do that the disposition of the case before us largely depends on the weight given to the considerations which there prevailed, recapitulation of them is appropriate. The Court there based its result on the conclusion that a transfer of property pursuant to an antenuptial settlement was not made in exchange for an "adequate and full consideration in money or money's worth." This conclusion was reinforced by reading into the gift tax provision the gloss of the interrelated estate tax of the same year that the relinquishment of "marital rights . . . shall not be considered to any extent a consideration 'in money or money's worth.' "

The case before us concerns not an antenuptial agreement, but what the Tax Court called a "property settlement agreement," contracted in anticipation of divorce. Each spouse transferred property of substantial value to the other and each agreed "to release completely the property of the other from all claims arising out of their marriage." 10 T.C. 741, 743.

Unless we are now to say that a settlement of property in winding up, as it were, a marriage, smacks more of a business arrangement than an antenuptial agreement and therefore satisfies the requirement of "an adequate and full consideration in money or money's worth" which we found wanting in Merrill v. Fahs, and unless we are further to overrule Merrill v. Fahs insofar as it joined the gift tax and the estate tax of the Revenue Act of 1932, so as to infuse into the gift tax the explicitness of the estate tax in precluding the surrender of marital rights from being deemed to any extent a consideration "in money or money's worth," we must hold that a settlement of property surrendering marital rights in anticipation of divorce is not made for "an adequate and full consideration in money or money's worth."

The same year that it enacted the gift tax Congress amended the estate tax by adding to the provision that "adequate and full consideration" was prerequisite to deduction of "claims against the estate" the phrase, "when founded upon a promise or agreement." [§2053(c)(1)(A)]. Legislative history demonstrates that this amendment was intended, not to change the law, but to make clear that the requirement of consideration did not prevent "deduction of liabilities imposed by law or arising out of torts." H.R. Rep. No. 708, 72d Cong., 1st Sess. 48; S. Rep. No. 665, 72d Cong., 1st Sess. 51. A similar principle is implicit in the gift tax. By its statutory language and authoritative commentaries thereon Congress did not leave the incidence of the gift tax at large by entrusting its application to the play of subtleties necessary to finding a "donative intent." Commissioner v. Wemyss, 324 U.S. 303, 306. But while by the gift tax Congress meant "to hit all the protean arrangements which the wit of man can devise that are not business transactions" to the common understanding, Commissioner v. Wemyss, ibid., a gift tax is an exaction which does presuppose the voluntary transfer of property and not a

transfer in obedience to law. In Merrill v. Fahs, supra, at 313, we stated that "to interpret the same phrase in the two taxes concerning the same subject matter in different ways where obvious reasons do not compel divergent treatment is to introduce another and needless complexity into this already irksome situation." Application of that principle would require the Court to hold that [§2512(b)] imposes a tax on "the amount by which the value of the property [transferred exceeds] the value of the consideration" received only when the transfer is "founded upon a promise or agreement." The taxpayer does not contest applicability of the principle; and in the view we take of the case it may be assumed.[2] Taxpayer contends (1) that the transfers in the situation now before us were or must be deemed to have been for an "adequate and full consideration in money or money's worth," and (2) that the Commissioner imposed a liability which was not "founded upon a promise or agreement." Her position was sustained by the Tax Court, 10 T.C. 741, but rejected by the Court of Appeals for the Second Circuit. 178 F.2d 861.

1. I would adhere to the views we expressed in the *Wemyss* and *Merrill* decisions as to the meaning to be given to the requirement of "adequate and full consideration" in the enforcement of the gift tax "in order to narrow the scope of tax exemptions." 324 U.S. at 312. Nor would I depart from the conclusion there reached that the relinquishment of marital rights is not to be deemed "money or money's worth" because that definition in the estate tax of 1932 is by implication to be read into the gift tax passed in the same year.

2. But was the transfer of the property here in controversy "founded upon a promise or agreement?" The answer requires recital of the governing facts of the case.

Taxpayer separated from her husband in August, 1942, and shortly thereafter brought suit in Nevada for divorce. One week prior to entry of the divorce decree, she and her husband entered into an agreement "for the purpose of settling the respective property rights of the parties hereto and of removing the subject matter thereof from the field of litigation." After providing for the transfers of property and the release of claims, the agreement recited,

> This agreement shall be submitted to the court for its approval, but nevertheless the covenants in this agreement shall survive any decree of divorce which may be entered. It is of the essence of this agreement that the settlement herein provided for shall not become operative in any manner nor shall any of the Recitals or covenants herein become binding upon either party unless a decree of absolute divorce between the parties shall be entered in the pending Nevada action. The settlement herein provided shall become immediately effective and operative in the event of and upon the entry of a decree of divorce between said parties in said pending Nevada action. The parties hereto, however, shall proceed as expeditiously as possible to carry into effect the covenants herein, which it is provided are to be performed by either of the parties prior to the entry of the decree as aforesaid.

After a hearing at which both parties were represented, the court granted the divorce. It found that certain transfers from the wife to the husband were "in discharge of a legal obligation which, because of the marital relationship has been imposed" on her; and concluded that "the agreement and trust agreements forming a part thereof, made and entered into between plaintiff and defendant under date of February 27th, 1943 is entitled to be approved." The divorce

[2] We therefore need not pass on the suggestion in the Government's brief that the estate and gift tax provisions should not in this instance be read in pari materia because the interpretation of a phrase common to the two statutes is not involved. Nor do we pass on the contention that under both gift and estate taxes liability is imposed on transfers and claims resulting from loss of marital rights even when no promise or agreement is involved.

decree "approved" the agreement, directed performance of two of its paragraphs, and declared,

> Notwithstanding the approval of said agreement and the trust agreements forming a part thereof by the Court herein, it is ordered that said agreement and said trust agreements forming a part thereof shall survive this decree. . . .
>
> It is further ordered, adjudged and decreed that the decree herein entered is absolute and final in all respects and the Court herein divests itself of all power to amend or modify the same in the future without the consent of both of the parties hereto.

The parties executed the provisions of the decree and the agreement, and the Commissioner assessed the tax in question on the amount by which the value of the property transferred by the wife to her husband exceeded the value of the property transferred by him to her.

3. Such being the facts of the case, was the transfer by Cornelia Harris "founded upon a promise or agreement?" The statute does not say founded "solely upon a promise or agreement." The statute does not say that the tax should not fall on "property transferred under the terms of a judgment or decree of the court." Nor is the phrase "founded upon agreement" a technical term having a well-known meaning either in law or in literature. The question really is whether the transfer made by the taxpayer to her husband was, within the fair meaning of the language, "founded" upon her agreement with her husband. Did the Nevada judge in decreeing the divorce describe what actually took place here when he said that on the "date of February 27, 1943, the plaintiff and defendant entered into an agreement and trust agreements forming a part thereof, under the terms of which the parties settled all obligations arising out of their marriage?"

The fact that undertakings defined by this agreement would come into force only on the occurrence of a condition, to wit, the entering of a decree of divorce, is apparently regarded as decisive of taxability. But does this make any real difference? The terms of that decree might be different from the terms of the agreement; but "nevertheless the covenants in this agreement shall survive any decree of divorce which may be entered." If the divorce court had disapproved the agreement and had not decreed the transfer of any property of the wife to her husband, it is difficult to see how transfers which she made, solely because of the compulsion of the agreement, would be effected by court decree and for that reason not subject to tax. The condition on which an agreement comes into force does not supplant an agreement any more than a deed in escrow ceases to be a deed when it comes out of escrow. In the *Wemyss* and *Merrill* cases would the gifts have been any the less founded upon an agreement if, as a condition to the antenuptial arrangements in those cases, the consent of the parents of the financée had been made a condition of the marriage? Nor can excluding the transfers here involved from the gift tax be made tenable by resting decision on the narrower ground that to the extent the divorce decree "approved" the agreement or embodied its provisions so as to make them enforceable by contempt the transfers were not "founded upon" the agreement within the meaning of the statute.[3] If the taxpayer had been sued by her husband for the

[3] The ground adopted for reversal of the court below is important to the disposition of the case. On the broader ground apparently employed, no gift tax is due. But if the narrower basis be used, it is probable that some liability should be imposed. One of the transfers required by the agreement — the wife's assumption of a $47,650 indebtedness of her husband — was not incorporated into the divorce decree and therefore is presumably enforceable only under the contract. If enforceability under the decree is the criterion, a gift tax is due to the extent this indebtedness is reflected in the amount determined by the Commissioner to represent the value attributable to release of marital rights.

sums she was obligated to transfer to him could he not have brought the suit on the contract? [4] Even though a promise for which inadequate consideration was given has been reduced to a judgment, a claim based upon it has been held not deductible from the gross estate and thus must have been deemed to be "founded upon a promise." Markwell's Estate v. Commissioner, 112 F.2d 253. If a transfer does not cease to be "founded upon a promise" when the promise is merged into a judgment, is not a transfer pursuant to an agreement which survives a ratifying decree a fortiori "founded upon" that agreement?

Judge Learned Hand's treatment of this matter is so hard-headed and convincing that it would be idle to paraphrase his views.

> In some jurisdictions contracts, made in anticipation of a divorce, are held to persist ex proprio vigore after the divorce decree has incorporated their terms, and has added its sanctions to those available in contract. That, for example, is the law of New York, where the contract remains obligatory even after the court has modified the allowances which it originally adopted; and where the promises will be thereafter enforced by execution and the like. Perhaps, that is also the law of Nevada, which the parties provided should govern "all matters affecting the interpretation of this agreement or the rights of the parties." Be that as it may, in the case at bar, the Nevada decree having declared that the agreement was "entitled to be approved," that included the provision that its "covenants" should "survive" as well as any of its other stipulations. Thus the payments made under it were "founded" as much upon the "promise or agreement" as upon the decree; indeed, they were "founded" upon both; the parties chose to submit themselves to two sanctions — contempt under the divorce court and execution under the contract. The payments were therefore subject to the gift tax. 178 F.2d 861, 865.

I would affirm the judgment.

ROSENTHAL v. COMMISSIONER
205 F.2d 505 (2d Cir. 1953)

Before AUGUSTUS N. HAND, CHASE, and CLARK, Circuit Judges.

CLARK, Circuit judge.

The taxpayer, Paul Rosenthal, petitions for review of a decision of Judge Disney in the Tax Court, reviewed by the entire court, 17 T.C. 1047, in so far as it determines a deficiency of $16,983.17 in his gift tax for 1946 and rejects his claim of overpayment of that tax in the amount of $160,212. In the same decision the court found a deficiency of $23,194.37 in Rosenthal's gift tax for 1944, but neither party has petitioned for review of this portion of the decision. At issue here is the taxability of certain obligations undertaken by Rosenthal toward his children in connection with his separation and subsequent divorce from his estranged wife. The basic facts were found by the court as stipulated by the parties and are not in dispute.

On July 26, 1944, Rosenthal entered into a separation agreement with his wife

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[4] In none of the twelve jurisdictions in which decisions in point have been found has it been held that a suit could not be brought on the contract in a situation like that before us. In four States actions may apparently be brought subsequent to divorce on prior separation agreements which are construed to contemplate survival even though the divorce decree directs different payments than the agreement. . . . In three States such suits may be brought at least where the decree is not inconsistent with the agreement and does not indicate an intention to terminate it. . . . In five others it appears that actions on the contract will lie except when the agreement is recited in the decree so as to be enforceable by contempt; but in none of the cases refusing to permit a suit on the contract did the decree or the agreement direct survival. . . . Schacht v. Schacht, 295 N.Y. 439, relied on by petitioner, held only that a determination by the divorce court of the fairness of a separation agreement was res judicata in a subsequent suit to set the agreement aside for fraud. The issue does not appear to have been determined in Nevada, where the agreement here involved was made and the divorce entered.

which contained a series of provisions for the education, care, support, and maintenance of their two children, Jill, then 20 years old, and Sue, aged 14. In these the taxpayer undertook: (1) To pay his wife for the benefit of the children $10,000 per annum for each daughter until she reaches the age of 21 or marries or until the wife dies; (2) To pay each child during her lifetime after she becomes 21 or marries, the sum of $8,000 annually until the death of the wife and $6,250 annually thereafter; and, if Rosenthal's mother dies during his lifetime, (3) To set up a trust for each child then living in the amount of $150,000, the income to be payable to the child for life, and upon her death the principal payable to her issue then living or, in default of issue, as the child may by will appoint, and (4) To pay to each of the children (or to the wife for the benefit of a minor child) an additional $3,000 annually until the death of the child or of the wife. The separation agreement also provided that, in the event of divorce, it should become a part of the decree or be considered "an agreement incident to such divorce"; its effectiveness, however, was not conditioned on the occurrence of a divorce. On September 18, 1944, taxpayer's wife did secure a Nevada divorce, and the July 26 agreement was expressly adopted by the court and made a part of its decree. The value of the taxpayer's obligations toward his children assumed in that agreement, as of both July 26 and September 18, 1944, was stipulated between the Commissioner and the taxpayer to be $499,340.98.

In 1945, Rosenthal sought to amend the separation agreement to translate so far as possible the annual payments due the children into one funded payment. The obligation to create trusts for them had already matured, since Rosenthal's mother died on November 19, 1944; and on May 14, 1945, the elder daughter, Jill, had reached the age of 21. Attorneys on both sides conducted the negotiations with the assistance of an accountant who calculated the value of taxpayer's existing obligation to make annual payments to both daughters, as of October 1, 1945, to be $357,000 under the Actuary's or Combined Experience Table of Mortality with interest at 4 per cent — the table then used by the Commissioner — or $453,000 under the Combined Annuity Mortality Table with interest at 3½ per cent, which the accountant regarded as "a more commercial table." Adding to these figures the obligation to create trusts at a face value of $300,000, the alternative computations of the worth of taxpayer's commitments become $657,000 or $753,000. The parties sought to retain the fair equivalent of these undertakings and ultimately reached agreement on what they considered a suitable modification on March 15, 1946. In lieu of the payments prescribed by the earlier agreement, the taxpayer was to establish on April 1, 1946, a trust for each daughter in the amount of $312,500, and to pay each during her lifetime $3,000 annually until the death of the wife and $1,500 annually thereafter. He also agreed to pay each child $5,021.33 as her "share of the income earned and allocable to the trusts provided for" in the original agreement. To differ from that agreement, these provisions were to become effective only upon appropriate amendment of the divorce decree, which was promptly ordered by the Nevada court on March 29, 1946. The total obligation assumed by the taxpayer under the new agreement was valued by the Commissioner at $729,737.67.

From 1944 through the first quarter of 1946, the taxpayer made all the direct payments called for by the original agreement, but did not actually set up the trusts upon the death of his mother. Taking the position that a gift tax became due only as non-exempt payments were made, he did not report any gifts to the children in 1944, since they were then both minors whom he was under an obligation to support; in 1945, however, he reported the payments made to Jill after she became 21. The payment — in the amount of $2,750 — made to Jill for the first three months of 1946 under the old agreement was likewise reported. In

addition, the taxpayer reported in his 1946 return payments made during that year under the new agreement amounting to $637,292.66.[1] A gift tax of $160,212 was paid on the $640,042.66 total of 1946 payments.

The Commissioner determined that the taxpayer should have included in his taxable gifts for 1946 the actuarial value in that year of the future annual payments to be made to both daughters under the revised agreement. In his notice of deficiency, the Commissioner valued the payments due Jill at $45,215.91, and those due Sue at $45,979.10. Accordingly, he added $91,195.01 to the taxable gifts and deducted therefrom $1,500[2] for the 1946 payments to Jill already reported. A deficiency of $39,848.36 was consequently assessed.

Seeking redetermination of this assessment in the Tax Court, the taxpayer contended not only that there was no additional tax due for 1946, but that he was entitled to refund of the $160,212 in taxes already paid, since none of the 1946 payments were properly taxable in that year. Two separate arguments were made in support of this claim. First, taxpayer contended that the 1946 agreement giving rise to these payments was made for an adequate and full consideration, namely, surrender of the children's rights under the 1944 agreement. Second, he argued that, since the 1946 agreement became effective only upon amendment of the divorce decree, payments thereunder were in discharge of a decretal obligation, and hence not taxable gifts. In addition to vigorously disputing both these contentions, the Commissioner countered on the first with the argument that, if the gifts made to the children were not taxable in 1946, a gift tax should have been paid on them in 1944 when the original agreement was executed. Since the taxpayer's 1944 gift tax return was also before the Tax Court in connection with the tax due on payments to his wife under the same 1944 agreement, the Commissioner maintained that adoption of taxpayer's first contention should result simply in a corresponding increase in his 1944 gift tax deficiency.

The Tax Court, however, deemed it unnecessary to examine this theory, for it rejected the taxpayer's two principal arguments in a comprehensive opinion by Disney, J., reviewed by the court. But it did agree with the taxpayer on the subsidiary point that the present worth in 1946 of the payments to be made to the younger daughter, Sue, during her minority, to the extent of $10,000 per annum, should not be included as taxable gifts, since these were in discharge of taxpayer's obligation to support his minor child. The 1946 gift tax deficiency was therefore reduced to $16,983.17, and this is the decision for which review is sought here by the taxpayer. The remaining part of the decision, for which neither party has sought review, is not immediately relevant here, since it determined a deficiency of $23,194.37 in the taxpayer's 1944 gift tax on the payments to his wife in that year.

The two principal contentions pressed by the taxpayer in the Tax Court also form the mainstay of his argument here; certain additional subsidiary claims not raised below will be discussed later. We may consider at the outset his interesting argument that his 1946 undertakings to make payments to or for the benefit of his children were wholly immunized from gift taxation because effective only upon incorporation into the divorce decree. For this proposition he relies chiefly on Harris v. C.I.R., 340 U.S. 106, which held a settlement of marital property rights between husband and wife, operative by its terms only on entry of a divorce

1 This figure comprises $625,000 for the two trusts set up under the 1946 agreement, plus the direct payment of $2,250 to Jill under that agreement, and also includes the $10,042.66 paid both children as their "share of the income earned and allocable to the trusts" provided for in the 1944 agreement.

2 As mentioned above and discussed later in this opinion, this figure should have been $2,250.

decree, to be exempt from gift taxes. The basis for this decision was the Court's holding that the settlement was founded not on a voluntary promise or agreement, but on the command of the divorce court, instructed by state law to decree a just and equitable disposition of the parties' property. Hence the arrangement was deemed in effect to be for "an adequate and full consideration in money or money's worth," [§2512(b)], the Court analogizing it to a transaction "in the ordinary course of business" which, under [Regs. §25.2512-8], satisfies the statutory requirement of a consideration to support the tax exemption. See also C.I.R. v. Converse, 2 Cir., 163 F.2d 131, 174 A.L.R. 199.

The rationale of both the *Harris* and *Converse* decisions rests basically on the divorce court's power, if not duty, to settle property rights as between the parties, either by adopting their own agreement as in the *Harris* case, or by having the matter litigated as in the *Converse* case. We do not find this rationale applicable to a decree ordering payments to adult offspring of the parties or to minors beyond their needs for support — the only payments with which we are now concerned, since that part of the taxpayer's undertakings necessary for the support of his children during their minority is concededly not taxable. See Helvering v. U.S. Trust Co., 2 Cir., 111 F.2d 576, certiorari denied U.S. Trust Co. of New York v. C.I.R., 311 U.S. 678, C.I.R. v. Weiser, 10 Cir., 113 F.2d 486. While neither the Nevada statute, Nev. Comp. Laws §§9462, 9463 (Supp. 1931-1941), nor interpretive decisions indicate the precise limits of the divorce court's authority in this area, courts of other jurisdictions operating under similar statutes have been restricted in their power to make awards of property to children to amounts appropriate merely for the maintenance of minor children. . . . Awards to children beyond their needs for support during minority have been held enforceable where based upon a contractual agreement between the parties to the divorce. . . . That is the situation here. But since such a decree provision depends for its validity wholly upon the consent of the party to be charged with the obligation and thus cannot be the product of litigation in the divorce court, we do not consider the rationale of the *Harris* decision applicable to the present case. We therefore conclude that the arrangements here made for the taxpayer's daughters beyond their support during minority do not obtain exemption from the federal gift tax by simply receiving the court's imprimatur. The similar result reached in Hooker v. C.I.R., 5 Cir., 174 F.2d 863, and Converse v. C.I.R., 5 T.C. 1014, affirmed C.I.R. v. Converse, supra, appears to us a correct interpretation of the law and not in conflict with the more recent decision in the *Harris* case.

This brings us to the question when the obligation undertaken by the taxpayer became taxable and whether there was in 1946 adequate and full consideration for the promises made in that year so as to take them out of the category of taxable gifts. In Harris v. C.I.R., 2 Cir., 178 F.2d 861, reversed on other grounds, 340 U.S. 106, we held that a binding promise to make a gift becomes subject to gift taxation in the year the obligation is undertaken and not when the discharging payments are made. The Seventh Circuit followed our decision on this point in C.I.R. v. Copley's Estate, 7 Cir., 194 F.2d 364. This view of the law was likewise adopted by the Commissioner and the Tax Court in the instant case in determining that a gift tax was due in 1946 on the then value of the future annual payments to be made to the taxpayer's daughters under the 1946 revised agreement. The Commissioner refused, however, to accord similar treatment to the promises made in 1944 — and hence to view their surrender as consideration for the 1946 undertakings — because part of the taxpayer's 1944 commitment was contingent on the death of his mother during his lifetime. With this we cannot agree. The obligation undertaken by the taxpayer in the 1944 agreement, which

was irrevocable without consent of the wife and the daughter affected once she became of age, at all times had an ascertainable value, since the stipulated contingency was susceptible to actuarial appraisal, even though it might conceivably never have come about. Robinette v. Helvering, 318 U.S. 184; see also C.I.R. v. Maresi, 2 Cir., 156 F.2d 929. The Commissioner indeed implicitly conceded this point when he stipulated the value of the taxpayer's obligation to his children under the 1944 agreement at the time of execution at $499,340.98. The possibility of valuation by actuarial tables distinguishes the present case from City Bank Farmers Trust Co. v. Hoey, 2 Cir., 101 F.2d 9, holding that payments made pursuant to court orders were taxable when made, since the court's orders were subject to modification at any time. See Harris v. C.I.R., supra, 178 F.2d at page 865. Thus the taxpayer's original promise here was taxable in 1944, and its surrender by the children in 1946 clearly constituted a valuable consideration for the new promise he then made.

Whether release of the 1944 obligation constituted "adequate and full consideration in money or money's worth" so as completely to exempt the 1946 promise from gift taxation under [§2512(b)], is of course another question. Treas. Reg. [§25.2512-8], referred to above, provides that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent), will be considered as made for an adequate and full consideration in money or money's worth." The Supreme Court's observations on this provision in the *Harris* case, 340 U.S. at page 112, are equally apposite here: "This transaction is not 'in the ordinary course of business' in any conventional sense. Few transactions between husband and wife ever would be; and those under the aegis of a divorce court are not. But if two partners on dissolution of the firm entered into a transaction of this character or if chancery did it for them, there would seem to be no doubt that the unscrambling of the business interests would satisfy the spirit of the Regulations. No reason is apparent why husband and wife should be under a heavier handicap absent a statute which brings all marital property settlements under the gift tax." We infer from this statement that even a family transaction may for gift tax purposes be treated as one "in the ordinary course of business" as defined in this Regulation if each of the parenthetical criteria is fully met.

C.I.R. v. Wemyss, 324 U.S. 303, suggests no contrary rule. It holds merely that the absence of donative intent as known to the common law will not alone prevent a transfer from being subject to gift taxation. . . . The Court noted in the *Wemyss* case, 324 U.S. at page 307, that the Tax Court had there in effect found that the transfer "was not made at arm's length in the ordinary course of business." In the instant case the Tax Court made no findings — express or even clearly implied — as to whether the surrender of the 1944 promise for the new 1946 obligation was a bona fide arm's length transaction without donative intent on the taxpayer's part. . . . The case must therefore be remanded to the Tax Court for determination of this question. If the court then finds that the 1946 agreement does represent the fruits of a bona fide arm's length transaction without donative intent, the 1946 deficiency will of course be expunged in toto and the taxpayer's refund claim allowed.

If, however, consideration of the criteria stated in the Regulation leads the court to the conclusion that there was here no transfer in the ordinary course of business as thus defined, it should proceed to determine the extent to which surrender of the children's rights under the 1944 agreement did constitute consideration for the taxpayer's 1946 undertaking. A gift tax is due only on the difference between this amount and the value of the new promise. [§2512(b)]. The Tax Court did not consider this issue when the case was originally before it because

the court believed that the taxpayer did "not suggest that there was some consideration but less than full and adequate." This seems to us too technical and restrictive a view of the argument presented to the court. Excerpts from that argument indicate that, while the taxpayer's main thrust was naturally enough to establish that there was no tax whatever due on the 1946 promise, he did not foreclose the alternative possibility of reduced tax liability because there was some consideration, though less than "adequate and full."

The taxpayer presents two final objections to the Tax Court's dispositon of this case. The first deals with the court's valuation of the younger daughter's right to support during her minority. In the Tax Court, taxpayer successfully contended that this non-taxable portion of his obligation should be valued at the actuarial worth of the $10,000 annual payments he undertook in the original separation agreement to make to his daughters during their minority; this the Commissioner calculated to be $44,695. While not challenging this computation, the taxpayer now contends for the first time that the minor daughter's right to support amounted to $67,6126.25, the stipulated value of all payments due her during minority under the 1946 agreement. Had this contention been presented to the Tax Court, it is of course possible that the taxpayer's method of valuation might have been adopted. That is, the Tax Court might have held that the obligation of support consisted of both the annual payment and the income from the trusts to be set up. But since the taxpayer was content to limit himself to an equally plausible theory — albeit less favorable to his case — we see no justification for requiring relitigation of this issue on remand.

[The court's discussion of two other issues — the computation point mentioned in footnote 2 supra, and the procedural question of whether the government was entitled to assert an additional deficiency for 1944 — is omitted. On the latter question, the court held that the issue was foreclosed by the government's failure to appeal from the Tax Court's decision as to 1944.]

NOTE

1. *Action on remand.* On remand, the Tax Court held that the 1946 agreement was a bona fide arm's-length transaction, there being no evidence that the taxpayer intended in 1946 to make gifts over and above those contemplated by the 1944 agreement. Rosenthal v. Commissioner, ¶54,152 P-H Memo T.C.

2. *Jurisdiction of divorce court.* Does the *Rosenthal* case assume that the divorce court's decree, to the extent it adopted the 1944 agreement, was a nullity that could have been disregarded by the taxpayer with impunity? (Note that the taxpayer took care to provide in the 1946 agreement that it would become effective only when the Nevada court amended its 1944 decree.) Or does the decision rest on the narrower premise that the divorce court could not, on its own motion, have required the taxpayer to support the children after their majority? What if local law authorized the divorce court to require such payments, at least as to children who are mentally or physically incapable of self-support?

If the divorce court has jurisdiction to divide the family property (as in *Harris*) and the husband, to avoid the risks of a court-imposed settlement, agrees to a "package" proposed by the wife (e.g., payments to her, to his mother-in-law, and to his children both during minority and thereafter), does *Rosenthal* require a gift tax to be paid on those elements of the package that could not have been independently imposed by the divorce court? What if the aggregate amount to be paid by the husband is no more than the amount he could have been compelled to pay to the ex-wife alone had the settlement been litigated before the divorce court?

Note that the government conceded in *Rosenthal* that the payments for the support of the children during minority were not taxable gifts — a concession that may have been based on E.T. 19, supra page 1033. If the husband agreed to make payments to the

children during their majority because they agreed to accept less than they were entitled to during their minority, could the husband have relied on §2512(b) (transfer for adequate and full consideration in money or money's worth) to avoid a gift tax?

In *Rosenthal,* the 1946 agreement called for payments to the taxpayer's daughters; their mother had died in 1945. If payments are to be made to an ex-wife "for" or "on behalf of" a child until he reaches the age of 30, would *Rosenthal* require a gift tax to be paid in respect of the payments to be made from age 21 to age 30? Are such payments made to the wife rather than to the child, so as to qualify under the *Harris* principle? What if the taxpayer agrees to pay the wife $25,000 per year, with the amount to be reduced to $20,000 when the child reaches the age of 30 or dies? See Lester v. Commissioner, supra page 184.

3. *Enactment of §2516 (property settlements followed by divorce).* Following the *Harris* and *Rosenthal* cases, Congress enacted §2516 as part of the 1954 Code. The Senate Report, recommending its enactment, states (p. 128): "Under present law property settlements between spouses are not regarded as taxable gifts if the property settlement is incorporated in the decree of divorce. However, the gift-tax status under present law of settlements not incorporated in the decree of divorce is uncertain." Note that §2516 speaks of "transfer . . . in settlement of . . . marital or property rights." If the wife gets more than the value of these rights, is the excess a taxable gift?

When applicable, §2516 permits a transfer to be made free of gift tax even if the agreement is not approved by the divorce court. The importance of the *Harris* case, so far as divorce settlements are concerned, is thus much reduced. But does *Harris* control the status after 1954 of marital settlements that do not meet the requirements of §2516? Consider the following possibilities:

(a) A property settlement under an agreement, with divorce occurring more than two years later. If the divorce court approves the settlement, is the transfer governed by the *Harris* case, or is §2516 now the exclusive route to tax exemption for divorce settlements?

(b) A property settlement under an agreement that is approved by a decree of legal separation, where the parties do not obtain a divorce. Is the *Harris* case applicable?

(c) Transfers to minor children in excess of a "reasonable allowance" for support. Even though such transfers are not sheltered by §2516, do they escape the gift tax if ordered by the divorce court?

(d) Prenuptial agreements. If Mr. Wemyss or Mr. Merrill had failed to perform their agreements until judgments were obtained against them by the ladies, would the satisfaction of the judgments be taxable under the *Harris* case? If a marriage is terminated by divorce within two years after an antenuptial agreement, does §2516 come into play as to the antenuptial transfers?

There is no estate tax provision parallel to §2516. As to the possibility that the divorced husband's estate will be unable to deduct unpaid installments of an obligation that would have been payable free of gift tax during his life under §2516, see page 1278 infra.

On the income tax consequences of a divorce settlement, see United States v. Davis, supra page 432.

4. *Payments to settle family disputes.* The Tax Court has on several occasions held that a payment in settlement of a serious family dispute over property was made for "adequate and full consideration in money or money's worth." Friedman's Estate v. Commissioner, 40 T.C. No. 75 (1963); Beveridge v. Commissioner, 10 T.C. 915 (1948); but see Housman v. Commissioner, 105 F.2d 973 (2d Cir. 1939), cert. denied, 309 U.S. 656. What about a payment to settle a dispute over the custody of a child or a claim for alienation of affections, or to avert a threatened exposure of a family disgrace?

5. *References.* Pedrick, The Gift Tax Jurisdiction of the Divorce Court, 46 Ill. L. Rev. 177 (1951); Note, Postmarital Settlements and the Gift Tax, 19 U. of Chi. L. Rev. 46 (1951); Taylor and Schwartz, Tax Aspects of Marital Property Agreements, 7 Tax L. Rev. 19, 38 et seq. (1951); Note, Consideration Under the Federal Estate and Gift Taxes, 37 N.Y.U.L. Rev. 82 (1962).

SECTION E. BUSINESS TRANSACTIONS

ESTATE OF ANDERSON v. COMMISSIONER
8 T.C. 706 (1947)

[Gift tax deficiencies of about $870,000 were determined by the Commissioner on transfers, in the circumstances related below, by M. D. Clayton and W. L. Clayton of 18,675 shares of common stock of Anderson-Clayton Securities Corporation to executives of the Corporation. The Corporation was the successor of an unincorporated enterprise, referred to in the opinion as "association."]

ARUNDELL, Judge.

At the threshold we are met with the question of whether the sales of stock by Anderson and Clayton to the six individuals actively engaged in the Anderson-Clayton business enterprise are in any event subject to gift tax. Respondent concedes that these sales were bona fide and at arm's length; but he contends that they were not made in the ordinary course of business, that the value of the stock was greater than the value of the consideration received, and that the excess is therefore taxable as a gift under [§2512(b)]. He relies primarily upon Commissioner v. Wemyss, 324 U.S. 303, for the proposition that the absence of donative intent is immaterial.

It is quite true that in *Wemyss* the Supreme Court held that Congress in [§2512-(b)] had dispensed with the subjective test of donative intent and substituted the more workable external or objective test of whether the consideration for the transfer is full and adequate in money or money's worth. It must not be overlooked, however, that at the same time the Court was careful to point out that genuine business transactions — "business transactions within the meaning of ordinary speech" — are not within the scope of the gift tax. Citing Treasury Regulations [§25.2512-8] it said that:

> . . . the Treasury Regulations make clear that no genuine business transaction comes within the purport of the gift tax by excluding "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent)." . . . Thus on finding that a transfer in the circumstances of a particular case is not made in the ordinary course of business, the transfer becomes subject to the gift tax to the extent that it is not made "for an adequate and full consideration in money or money's worth."

The first issue therefore reduces itself to the question of whether the sales of common stock of corporation were "made in the ordinary course of business." Petitioners contend that the sales were so made. They argue that, while donative intent may not be material in determining whether a gift has been made, the presence or absence of donative intent is an important circumstance in determining whether a sale or other disposition of property is made in the ordinary course of business. The regulations, they say, define a transfer made in the ordinary course of business as "a transaction which is bona fide, at arm's length, and free from any donative intent."

For the purposes of deciding the first issue thus raised, we shall assume that the stock had a value in excess of the consideration.

All the sales of stock were made pursuant to what was essentially a profit-sharing plan. Profit participation by the active management was a common practice in the cotton merchandising business generally. The evidence makes clear that cotton merchandising is primarily a management business and one of the most

difficult and complex merchandising operations in the world, and that the success of the business is dependent, by and large, upon efficient and well trained management having long experience in all phases of cotton merchandising.

Prior to the organization of corporation, Clayton, Fleming, and Whittington held profit sharing or commission contracts with association which yielded them large annual returns and removed considerable cash from the business. When corporation was organized, its common stock was substituted for the profit sharing contracts; and that had the two-fold effect of keeping cash in the business as invested capital and compelling the executives to acquire a proprietary interest in the business. From the beginning, the common stock of corporation was designed to be held only by persons actively engaged in the Anderson-Clayton business enterprise. Clayton and Anderson were the holders of the largest equities in the business, and the real value of their large investments in preferred stock could be maintained and preserved only by a continued efficient management. In order to build up a responsible management which could continue the business in the event of the retirement or death of Anderson or Clayton, they believed it essential that the junior executives acquire proprietary interests in the business and that such proprietary interests should grow in proportion to the shifting of responsibilities from the seniors to the juniors.

And so the plan was put into operation upon the organization of corporation. All the common stockholders understood that the relative proportions of their holdings would change from time to time as responsibilities were shifted from the older to the younger executives. At the beginning of each cotton season it was customary to reexamine the management situation and the relative contributions to management on the part of the several executives and to determine what readjustments, if any, in the relative ownership of common stock should be made. All the sales of common stock here in issue, as well as other sales not in issue, were made pursuant to the agreement between corporation and all the common stockholders, all of whom were actively engaged in the business. Under that agreement a method was provided for determining annually, in accordance with a consolidated balance sheet adjusted so as to reflect the true net worth of the consolidated business enterprise, a price at which transfers of the common stock should be made. The holders of 75 per cent of the common stock could direct any party to sell all or any part of his stock to corporation or to such person as they might designate. No party could sell or otherwise dispose of his common stock without the written consent of 75 per cent of the holders. If any party should elect to withdraw from the business, he had to sell his stock to corporation. If any party should die, his stock was to be purchased by corporation. No cash dividend could be paid on common stock so long as corporation was indebted in any sum whatever. Other provisions of the agreement are set out in our findings and need not be repeated here. It was contemplated not only that Clayton and Anderson would sell some of their common stock from time to time to their juniors, but also that as the latter should pass the peak of responsibility, they in turn would sell part of their holdings to their juniors who were taking on more responsibility. In other words, the common stock was designed not to be marketable, but to be held in direct proportion to the active participation of each stockholder in the business enterprise.

It is obvious from all these circumstances that the sales of common stock were motivated by the peculiar importance of expert and continuous management to the cotton merchandising business. They were intended to preserve or augment the value of the estates of Clayton and Anderson, as well as to relieve them of obligations to corporation. All the vendees of the stock were either at the time of the sales or shortly thereafter, managing executives in association and held

qualifying shares to make them fully liable for the debts of association. Association being a modified form of partnership, the vendees were partners with Anderson and Clayton in the operating entity of the business enterprise. There was no intent on the part of Anderson and Clayton in selling the stock to confer, nor intent on the part of their vendees to receive, gratuitous benefits. Clearly, then, these transactions were not gifts in any ordinary sense of the word.

In contending that the sales of stock were not "made in the ordinary course of business," respondent's position appears to be that it was neither ordinary for Anderson and Clayton nor ordinary for business men in general to enter into transactions of the type here involved. We do not agree. On the contrary, it is apparent from the numerous occasions on which Clayton and Anderson sold common stock to their junior executives, both those in issue and others not in issue, that it was a quite customary and ordinary thing for them to do. The record also proves that profit sharing or participation among the active management was quite the ordinary and customary practice in the cotton merchandising business generally. Furthermore, from facts within the range of judicial knowledge, we know that nothing is more ordinary, as business is conducted in this country, than profit-sharing arrangements and plans for the acquisition of proprietary interests by junior executives or junior partners, often for inadequate consideration, if consideration is to be measured solely in terms of money or something reducible to a money value.

The cases of Deputy v. DuPont, 308 U.S. 488, and Welch v. Helvering [supra p. 255], relied on by respondent, have little if any bearing on the problem here presented. Both cases deal with expense deductions for income tax purposes under a statute providing for the allowance of "ordinary and necessary expenses paid or incurred . . . *in carrying on any trade or business.*" (Italics supplied.) It does not follow that considerations which are relevant in determining whether an item of expense is an "ordinary and necessary" business expense for purposes of income tax deduction are relevant in determining whether a transfer of property is made "in the ordinary course of business" for purposes of the gift tax.

The pertinent inquiry for gift tax purposes is whether the transaction is a *genuine business* transaction, as distinguished, for example, from the marital or family type of transaction involved in *Wemyss* and its companion case, Merrill v. Fahs, 324 U.S. 308. Surely it will not be said that there may not be a genuine business transaction not directly connected with the taxpayer's trade or business or even though the taxpayer be not engaged in "carrying on any trade or business," within the scope of that term as limited by Higgins v. Commissioner, 312 U.S. 212. Bad bargains, sales for less than market, sales for less than adequate consideration in money or money's worth are made every day in the business world, for one reason or another; but no one would think for a moment that any gift is involved, even in the broadest possible sense of the term "gift."

It appears that this is the first attempt on the part of the respondent to apply the gift tax to transactions such as those presented here. To sustain the attempt, in our judgment, would be to work a perversion of the whole purpose and spirit of the gift tax law. However broadly Congress may have used the term "gifts" in the gift tax law, and however much it may have dispensed with common law concepts of gifts, we are certain that the law was neither designed nor intended in its operation to hamper or straight-jacket the ordinary conduct of business.

We have found that the sales of stock in issue were bona fide and made at arm's length, in the ordinary course of business. Therefore, assuming, without deciding, that the value of the stock was greater than the value of the consideration, we hold that the transfers are not subject to gift tax. This makes it unnecessary to decide the question of value or to determine in which calendar years

certain of the transfers were effected, and we have accordingly made no findings of fact with respect to these questions.

Reviewed by the Court.

Decisions will be entered for the petitioners.

NOTE

1. *Shareholders' agreements.* The shareholders of closely held corporations often agree that the shares of a deceased shareholder must be offered to the other shareholders at book value (i.e., without taking goodwill or appreciation in the value of real estate or other assets into account). If such an agreement imposes a similar requirement on retired shareholders, does *Anderson's Estate* insure that no gift tax liability is incurred, either when the agreement is executed or when the shares are sold for less than their unrestricted value? What if the shareholders are members of the same family? See page 1349 infra.

2. *Transactions with family businesses.* In Rothrock v. Commissioner, 7 T.C. 848 (1946), the court held that the taxpayer and his business partner did not make taxable gifts to their sons when they took them into the business as partners:

> The issue, as we see it, narrows to whether the prospective earnings of the sons were attributable purely to personal services, or partly to the contribution made by the existence and continuation of a going concern — in other words to a share in presently valuable business prospects, comparable to good will, which being the property of the old partnership was in some measure transferred to them as members of the new firm.
>
> It is not requisite to put too fine a point upon the principle involved in that distinction. If in fact there were no future earnings inherent in the business itself, it matters little whether we say, as a matter of law, there was a gift, see William H. Gross, 7 T.C. 837, but its value was so negligible as to eliminate it from practical consideration; or the value being absent, the consideration passing could not fail to be full and adequate; or, there being no existing vehicle for the transmission of future earnings in such a purely personal service business, cf. Tinkoff v. Commissioner (C.C.A., 7th Cir.), 120 Fed. (2d) 564; Thomas M. McIntyre, 37 B.T.A. 812, there was nothing which could be the subject of a gift. On any approach the result is identical.
>
> Our interpretation of the evidentiary facts leads us to the ultimate finding that petitioners have borne their burden of showing that the business by itself possessed no substantial element of future earning power or good will, but that, on the contrary, its income was derived primarily from personal services, so that different participants with similar abilities, experience, and contacts could have organized a comparable venture and enjoyed a parallel success from their contribution of time, skills, and services. See, e.g., Amalgamated Products Co., 12 B.T.A. 659. This factor, coupled with the proven capacity of the respective sons and the value to the business of their contributions, results in our inability to discover any gift of interests, tangible or intangible, direct or indirect, to which the tax could attach.

Is there any relationship between this finding and the reference in §704(e)(1) to a "capital interest in a partnership in which capital is a material income-producing factor"? In the *Gross* case, distinguished by the court, a gift was found because the partnership's trade name, goodwill, and secret formulas were valuable. Under *Rothrock,* however, could these values be disregarded if the son's services were reasonably thought to be essential to the future conduct of the business? See Heringer v. Commissioner, 235 F.2d 149 (9th Cir. 1956), cert. denied, 352 U.S. 927 (1956), in which the taxpayers transferred a valuable farm to a family corporation, in which they and their children were shareholders; their argument that the transfer was not a gift because intended "to provide for said children an incentive to work the farm more productively, thus placing the transactions in the category of transactions in the ordinary course of business and without donative intent" was rejected as not in accord with the facts.

See also Hull v. Commissioner, ¶62,199 P-H Memo T.C. (property worth $471,000 transferred to family corporation for annuity worth $214,000; held, not a gift even though

49 per cent of stock was owned by or for members of transferor's family, because she was relieved of management responsibility and believed that she received full value); Weller v. Commissioner, 38 T.C. 790, 805-807 (1962).

3. *Business "gifts."* If a businessman gives a friend a Cadillac for some business advice (Commissioner v. Duberstein, supra p. 119), is the transfer subject to gift tax? What if an employer makes a payment, or a series of payments, to the widow of a deceased employee, motivated by affection or a charitable concern for her welfare? If a businessman pays $25,000 to a member of the public because he is at home when the phone rings, knows that George Washington was the first President of the United States, or catches a marked fish in a contest (Simmons v. United States, supra p. 137), has he made a taxable gift?

Is a bribe a taxable gift if the "consideration" is valuable but unlawful? Should Reinfeld have paid a gift tax when he paid off Rutkin (see United States v. Rutkin, supra p. 105)? What about a gift to a young lady for granting the donor the exclusive right to her "companionship" (See Brizendine v. Commissioner, supra p. 127)?

The cancellation of indebtedness by the creditor of a business corporation was held to be a "gift" (and hence excluded from the debtor corporation's gross income by what is now §102(a) of the Internal Revenue Code) in Helvering v. American Dental Co., 318 U.S. 322, 331 (1943): "The fact that the motives leading to the cancellation were those of business or even selfish, if it be true, is not significant. The forgiveness was gratuitous, a release of something to the debtor for nothing, and sufficient to make the cancellation here gifts within the [income tax] statute." Is a gift tax due? (The *American Dental Co.* case was severely limited by Commissioner v. Jacobson, supra page 91.)

4. *Prizes and awards.* If the taxpayer offers a prize for the best essay on a subject of public interest or a reward for information leading to the capture of a public enemy, does the payment escape gift tax as a business transaction, or because he has received adequate consideration? See Du Pont v. United States, 97 F. Supp. 944 (D. Del. 1951) (contribution to National Economic Council, to encourage private enterprise and further general welfare; held, taxable gift). What of a reward for the return of lost property? A payment to a grandchild for avoiding tobacco, liquor, and loose women until reaching the age of 21?

5. *References.* Note, Taxation of Gifts to Closely Held Corporations, 57 Colum. L. Rev. 240 (1957); Note, Tax Consequences of Gifts of Property to Closely Held Corporations, 66 Harv. L. Rev. 334 (1952); McDowell, Gift Tax Problems in Organization and Reorganization of Family Corporations, 20 N.Y.U. Inst. on Fed. Taxation (1962).

SECTION F. THE ANNUAL EXCLUSION

UNITED STATES v. PELZER
312 U.S. 399 (1941)

MR. JUSTICE STONE delivered the opinion of the Court.

Decision in this case turns on the question whether certain gifts of property in trust for the benefit of several beneficiaries are gifts of "future interests" which, in the computation of the gift tax, are, by §504(b) of the 1932 Revenue Act denied the benefit, otherwise allowed, of exclusion from the computation to the extent of the first $5,000 of each gift "made to any person by the donor" during the calendar year.* . . .

In 1932 the taxpayer, respondent here, created a trust for the benefit of his eight grandchildren and any other grandchildren who might afterward be born during the term of the trust. The trustee was directed to accumulate the income for a period of ten years and thereafter to pay an "equal grandchild's distributive share" of the income to each of the named grandchildren who were then living

* The exclusion was reduced to $4000 by the Revenue Act of 1938 and to $3000 by the Revenue Act of 1942. The applicable provision of current law is §2503(b). — ED.

and twenty-one years of age and to pay a like share of income to each other named grandchild for life after that child should reach the age of twenty-one years. Provision was made whereby grandchildren born after the creation of the trust and during its life were to receive like participation in the income of the trust except as to distributions of income made prior to the birth of such after-born grandchildren, and except that the after-born grandchildren should be paid their shares of the income during their respective minorities after the termination of the ten-year accumulation period. The trust instrument also made gifts over of the share of the income of each grandchild at death, the details of which are not now material. It was further provided that the trust should terminate twenty-one years after death of the last survivor of the named grandchildren, when the corpus of the trust, with accumulated income, was to be distributed in equal shares among the surviving grandchildren and the issue per stirpes of all deceased grandchildren.

During the years 1933, 1934, and 1935, the taxpayer added further amounts of property to the 1932 trust. . . .

Upon claims for refunds of overpaid taxes upon the transfers made in the years 1933, 1934, and 1935, the commissioner recomputed the tax and allowed one $5,000 exclusion only from the net amounts subject to gift tax given or added in each year to each trust. In the present suit, brought in the Court of Claims, respondent sought to recover overpaid taxes for the years in question on the grounds that the gifts to the beneficiaries were gifts of present, not future, interests and that the taxpayer in the computation of the tax for each year was entitled to one exclusion of $5,000 for each beneficiary. The court sustained both contentions and gave judgment for respondent accordingly. 31 F. Supp. 770. We granted certiorari, 311 U.S. 634, to resolve the conflict of the decision below with that of the Seventh Circuit in United States v. Ryerson, 114 F.2d 150.

The Government challenges both grounds of decision below. It argues that only a single $5,000 exclusion is allowable . . . from the total gifts made to the trust in each calendar year and that if the gifts are deemed to be made to the named beneficiaries of the trust no deduction can be allowed in the case of gifts to the 1932 trust because they were of future interests for which no exclusion is allowed. . . .

We have this day decided the first question, in Helvering v. Hutchings, 312 U.S. 393, in which we held that in the case of gifts in trust the beneficiaries are the persons to whom the gifts are made and that for purposes of computation of the tax [§2503(b)] excludes the first $5,000 in value of the gift to each beneficiary from the taxable amount of the gifts made in the calendar year. For the reasons stated in our opinion in that case we hold that the first beneficiaries of the trusts in this case are the persons to whom the gifts were made and that the taxpayer is entitled to the benefit of the $5,000 exclusion for each gift to such beneficiary if it is not of a future interest.*

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* Helvering v. Hutchings, 312 U.S. 393:

"The gift tax provisions are not concerned with mere transfers of legal title to the trustee without surrender by the donor of the economic benefits of ownership and his control over them. A gift to a trustee reserving to the donor the economic benefit of the trust or the power of its disposition, involves no taxable gift. It is only upon the surrender by the donor of the benefit or power reserved to himself that a taxable gift occurs . . . and it would seem to follow that the beneficiary of the trust to whose benefit the surrender inures, whether made at the time the trust is created or later, is the 'person' or 'individual' to whom the gift is made.

"But for present purposes it is of more importance that in common understanding and in the common use of language a gift is made to him upon whom the donor bestows the benefit of his donation. One does not speak of making a gift to a trust rather than to his children who are its beneficiaries. The reports of the committees of Congress used words in their natural sense and

But the Government argues here, as it did below, that the gifts to the beneficiaries of the 1932 trust are of future interests within the meaning of the statute and treasury regulations. While the eight named grandchildren are the first beneficiaries of the trust, and the persons to whom the gifts were made, none of them takes any benefit from the trust before the end of the ten-year accumulation period or until he is twenty-one, whichever last occurs, and then only if he survives that event. And the question is whether such a gift is a gift of a "future interest" within the meaning of [§2503(b)]. Respondent, relying on statutes and judicial decisions of Alabama, where the trust was created and is being administered, insists that the gifts to the named grandchildren are present, not future, interests as defined by Alabama law. He argues that as [§2503(b)] does not define the "future interests" gifts of which are excluded from its benefits, they must be taken to be future interests as defined by the local law, and it is the local law definition of future interests which must be adopted in applying the section. But as we have often had occasion to point out, the revenue laws are to be construed in the light of their general purpose to establish a nationwide scheme of taxation uniform in its application. Hence their provisions are not to be taken as subject to state control or limitation unless the language or necessary implication of the section involved makes its application dependent on state law. Burnet v. Harmel, 287 U.S. 103, 110; Morgan v. Commissioner, 309 U.S. 78, 81.

We find no such implication in the exclusion of gifts of "future interests" from the benefits given by [§2503(b)]. In the absence of any statutory definition of the phrase we look to the purpose of the statute to ascertain what is intended. It plainly is not concerned with the varying local definitions of property interests or with the local refinements of coveyancing, and there is no reason for supposing that the extent of the granted tax exemption was intended to be given a corresponding variation. Its purpose was rather the protection of the revenue and the appropriate administration of the tax immunity provided by the statute. It is this purpose which marks the boundaries of the statutory command. The committee reports recommending the legislation declared (H. Rept. No. 708, 72d Cong., 1st Sess., p. 29; S. Rept. No. 665, 72d Cong., 1st Sess., p. 41):

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in the sense in which we must take it they were intended to be used in [§2503(b)] when, in discussing [§2501(a)], they spoke of the beneficiary of a gift upon trust as the person to whom the gift is made. Similarly they spoke of gifts effected by transfer of money or property to another as consideration for the payment of money or other property to a third person as a gift to the third person. . . . It is of some significance also that the denial . . . of the exemption in the case of gifts of 'future interests' has little scope for practical operation unless the gifts to which the exemption applies include those gifts made to beneficiaries of a trust, since it is by resort to the conveyance in trust that most future interests are created.

"Moreover, the very purpose of allowing a gift tax exemption measured by the number of donees would be defeated if a distinction were to be taken between gifts made directly to numerous donees and a gift made for their benefit by way of a single trust, and we are unable to discern in the statute or its legislative history any purpose to make such a distinction. While one object of the exemption was to permit small tax free gifts, and at the same time 'to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts' without the necessity of keeping accounts and reporting the gifts, nevertheless the statute extended the exemption in the specified amount to all gifts, whether large or small, 'made to any person.'

"In the face of an exemption thus made broadly applicable to all gifts to all donees and in the absence of some indication of an intention to discriminate between gifts made directly to the donees and those made indirectly to the beneficiaries of a trust, we can hardly assume a purpose to favor one class of donees over the other or find such a purpose in the words of the statutory definition of 'person' which may indicate either the trust or each individual beneficiary of the trust as the person to whom the gift is made. Further, such an assumption would open the way to avoid the $5,000 limitation upon the allowed exemption, by resort to the simple expedient of the creation by a single donor of any number of trusts of $5,000 each for the benefit of a single beneficiary. A construction so dependent upon an artificial meaning of the words of the statute and so out of harmony with the statutory scheme and purpose is not to be favored." — Ed.

The term "future interests in property" refers to any interest or estate, whether vested or contingent, limited to commence in possession or enjoyment at a future date. The exemption being available only in so far as the donees are ascertainable, the denial of the exemption in the case of gifts of future interests is dictated by the apprehended difficulty, in many instances, of determining the number of eventual donees and the values of their respective gifts.

Article XI of Treasury Regulations 79, 1933 and 1926 editions [now Regs. §25.2503-3] declared that "future interests" include any interest or estate "whether vested or contingent, limited to commence in use, possession, or enjoyment at some future date or time." . . .

We think that the regulations, so far as they are applicable to the present gifts, are within the competence of the Treasury in interpreting [§2503(b)] and effect its purpose as declared by the reports of the Congressional committees, and that the gifts to the eight beneficiaries of the 1932 trust were gifts of future interests which are excluded from the benefits of that section. Here the beneficiaries had no right to the present enjoyment of the corpus or of the income and unless they survive the ten-year period they will never receive any part of either. The "use, possession, or enjoyment" of each donee is thus postponed to the happening of a future uncertain event. The gift thus involved the difficulties of determining the "number of eventual donees and the value of their respective gifts" which it was the purpose of the statute to avoid.

We have no occasion to consider the definition of future interests in other aspects than those presented by the present case. The judgment of the Court of Claims will be reversed so far only as it excluded the gifts to the 1932 trust from the computation of the tax for each of the years in question.

Reversed.

NOTE

1. *The function of the annual exclusion.* In recommending an exclusion of $5000 in 1932, the Senate Finance Committee described its purpose as follows:

> Such exemption, on the one hand, is to obviate the necessity of keeping an account of and reporting numerous small gifts, and, on the other, to fix the amount sufficiently large to cover in most cases wedding and Christmas gifts and occasional gifts of relatively small amounts. [S. Rept. No. 665, 72d Cong., 1st Sess., reprinted in 1939-1 C.B. (Part 2) 496, 525-526.]

Even though the amount excluded has been reduced to $3000, the parents of 3 children, by pooling their exclusions and exemptions as permitted by the "split gift" provision (infra p. 1112), can transfer $18,000 ($6000 per child) per year free of gift tax; in 10 years, this amount plus their $60,000 lifetime exemption will amount to almost a quarter of a million dollars.

Note the reason given in the extract from the Congressional reports in *Pelzer* for denying the exclusion to gifts of future interests. Is there any difficulty in determining that there will be at least *one* "eventual donee" of the 1932 trust in the *Pelzer* case? In Rev. Rul. 55-679, 1955-2 C.B. 390, the Internal Revenue Service addressed itself to the proper number of exclusions for a trust under which the income was to be paid quarterly for a 10-year period to such of the grantor's grandchildren as might be living at the time of each payment, after-born grandchildren being entitled to share along with these living at the time the trust was created. The Service held that if a minimum value could be assigned to the interests of the grandchildren living when the trust was created — e.g., on the assumption that the maximum number of additional grandchildren who could share in the income during the 10-year life of the trust was 50 — exclusions were allowable for the 10 living grandchildren even though the number of eventual donees was not ascertainable. See also Rev. Rul. 55-678, 1955-2 C.B. 389, to the same effect.

In Faulkner v. Commissioner, 41 B.T.A. 875 (1940), the taxpayer was allowed an exclusion for a gift in trust for her first child to be born after the date of the gift. Would the exclusion be permitted under the rationale of the subsequently decided *Pelzer* case? The taxpayer made a contribution in the same year to the Birth Control League of Massachusetts: should that have weakened her claim for an exclusion? What effect should be given to the fact that she was pregnant when she made the gift?

2. *Support trusts.* In Commissioner v. Disston, 325 U.S. 442 (1945), the trustees were to accumulate trust income for future distribution to the beneficiaries, subject to a power to distribute currently such income "as may be necessary for the education, comfort and support" of minor beneficiaries. The Court denied an exclusion on the ground that the trustees had discretion to distribute or withhold income, but went on to say:

> But, even though the trustees were under a duty to apply the income for support, irrespective of outside sources of revenue, there is always the question how much, if any, of the income can actually be applied for the permitted purposes. The existence of a duty so to apply the income gives no clue to the amount that will be needed for that purpose, or the requirements for maintenance, education and support that were foreseeable at the time the gifts were made. In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the minor would be required, there is no basis for a conclusion that there is a gift of anything other than for the future. The taxpayer claiming the exclusion must assume the burden of showing that the value of what he claims is other than a future interest. [325 U.S. at 448-449.]

See also Commissioner v. Sharp, 153 F.2d 163 (9th Cir. 1946) (trustee required to use income for minor's benefit, but could do so by spending funds itself or paying them to minor's mother or guardian; held, exclusion allowable).

3. *Gift of income for life or a term.* At one time, the Treasury took the position that a life estate is a future interest, except for the income to be paid to the donee in the year of the gift, because the annual installments are to be paid at future times. Several cases holding to the contrary were apparently approved by the Supreme Court in Fondren v. Commissioner, 324 U.S. 18, 21 (1945): ". . . it has been held that if the income of a trust is required to be distributed periodically, as annually, but distribution of the corpus is deferred, the gift of the income is one of a present interest, that of the corpus one in futuro." In Charles v. Hassett, 43 F. Supp. 432, 434-435 (D. Mass. 1942), the court pointed out some of the implications of holding that a life estate is a present interest but a remainder a future interest:

> If a gift of $5,000 to trustees to pay the income to *A* for life is a present interest, what is to be said of these gifts: (1) $200 to *A* each year so long as he lives; (2) $200 to *A* the first year, if he lives, $300 to *A* the second year, if he lives, $400 to *A* the third year, if he lives, etc.; (3) $200 to *A* the first year, if he lives, $200 to *A* the second year, if he lives, etc. and $5,000 to *A* the fifteenth year, if he lives; and finally, (4) the income on $5,000 to *A* each year he lives for the next fifteen years, and then $5,000 to *A* in the fifteenth year?
>
> To the argument implied in that progression, the answer is that historically lawyers have treated gifts of income beginning at once and lasting for life, or for a period of years, as a "present interest" and gifts of principal at a future date as a "future interest"; that Congressional committees and the Treasury appear to have had some such distinction in mind; and that this and other circuits in construing the gift tax statute have used that line of distinction in cases where the gifts of income and of principal were to different persons. . . . No historical reason justifies abandoning the distinction in cases where the gifts of income and of principal are to the same person and are therefore regarded by donor and donee as one gift.

The court then pointed out the "anomalous" result that the donor may pay a heavier gift tax if he gives his donee the income of a short-term trust than if the trust is of longer duration, even though the remainder is to go to the same donee on the termination of the trust. To illustrate:

> Suppose $5000 is transferred in trust to pay the income to A (who is now 15 years old)

for 10 years or life, whichever is shorter, the remainder to be paid to him or his estate on the termination of the trust. Assuming an annual return of $175 (3½ per cent), A's income interest is worth $1445 and the remainder interest is worth $3555. (Table X, Actuarial Values for Estate and Gift Tax, Treasury Publ. No. 11.) If the trust is for 20 years or A's life (whichever is shorter), however, with remainder to A or his estate, the income interest is worth $2450, and the remainder is worth $2550. (Id., Example 11.) Since only the income interests qualify for the exclusion, the taxable gift is $3555 in the first case and $2550 in the second, although in the first case the donee will obtain outright ownership earlier than in the second case. Note, however, that this odd result is produced only because the shorter trust "wastes" more of the $3000 exclusion than the larger one. The trusts would be taxed identically if both life interests exceeded $3000 in value. Thus if the amount involved were $15,000, there would be a taxable gift of $12,000 whether the term of the trust was 10 years or 20.

A similar paradox is exemplified by Evans v. Commissioner, 198 F.2d 435 (3d Cir. 1952), involving a trust under which the income was payable to a named beneficiary for life, with a power in the trustee in its "uncontrolled discretion" to advance principal for his "education, comfort and support." Although the Treasury conceded that to the extent of the life interest the gift was not a gift of a future interest, it contended that the value of this part of the gift could not be determined because of the trustee's power to invade principal. The court agreed, and denied the exclusion. The decision was overruled by the second sentence of §2503(b), added in 1954.

4. *Effect of spendthrift clause.* Revenue Rul. 54-344, 1954-2 C.B. 319, adopts the position that a gift of the present right to enjoy the income of a trust for a period of years or for life "will not be held to be one of a future interest in property solely because of the inclusion of a provision or clause which prohibits the income beneficiary from alienating, assigning or otherwise anticipating such income."

5. *Gifts of contractual rights to future payments.* The Regulations provide that a gift of a bond qualifies for the exclusion even though it bears no interest until maturity, and that a policy of life insurance also qualifies even though it calls for payments in the future. Regs. §25.2503-3(a); see also Rev. Rul. 55-408, 1955-1 C.B. 113 (exclusion allowed for gift of insurance policy despite lack of cash surrender value). Why this distinction between future payments under a contract, the value of which is a present interest qualifying for the exclusion, and a remainder or similar interest in a trust, which does not qualify? How is a gift of an annuity contract to be treated, if payments are to commence at a future date? Roberts v. Commissioner, 143 F.2d 657 (5th Cir. 1944), cert. denied, 324 U.S. 841 (1945). If the donor does not create a future interest, but transfers one that is already in existence (e.g., his remainder interest under a trust created by his father), does the exclusion apply?

6. *Gifts of unproductive property.* In Gilmore v. Commissioner, infra page 1059, the court held that a trustee's power to invest in non-productive property did not deprive the income beneficiary of a present interest:

> . . . the trust gives the donee the absolute right to all income. The fact that there may not be income during a year is not a contingency imposed by the donor. It is the right of a donee to the income, rather than the accident of whether there is income at any given time, that is the criterion of present interest. That the corpus of a trust may consist of non-interest bearing notes, payable at a future date, does not prevent a gift from being one of present interest. Commissioner of Internal Revenue v. Kempner, 5 Cir., 126 F.2d 853. [213 F.2d at 522.]

If the trustee not only has the power to invest in non-productive property, but is likely to exercise it, how can the beneficiary's income interest be valued? See Geller v. Commissioner, 9 T.C. 484 (1947) (gift of income interest under trust could not be valued where corpus consisted of stock of closely held corporation that was not paying dividends).

7. *Gifts to corporations.* In Scanlon v. Commissioner, 42 B.T.A. 997 (1940), the court held that a transfer of property to a corporation wholly owned by the transferor was not a taxable gift; and in Heringer v. Commissioner, 235 F.2d 149 (9th Cir. 1956), cert. denied, 352 U.S. 927 (1957), where property was transferred by four persons to a corporation of which they owned 40 per cent of the stock, the court cited Helvering v. Hutchings (supra

p. 1054) in holding that the amount of the gift was 60 per cent of the value of the property, that being the amount that inured to the benefit of the non-donor shareholders (11 children of the transferors). As to the proper number of exclusions, however, the opinion is indecisive. Each donor had claimed 11 exclusions, on the ground that the donees were the 11 children; but the Tax Court allowed only one exclusion to each donor, on the theory that the donee was the corporation. On appeal, the court held that if the 11 children were the donees (a question it found unnecessary to answer), the gifts were of future interests because:

> Shareholders of the corporation could possess or enjoy the land or income derived therefrom only upon declaration of dividends, an act which required the joint action of members of the competent corporate body and which no single shareholder could perform. [235 F.2d at 152.]

(Since the government had not appealed, the Tax Court's action in allowing one exclusion to each donor was not disturbed.) Does this ground for denying the exclusions claimed by the taxpayer imply that a gift of stock of a closely held corporation does not qualify for an exclusion if it constitutes a minority interest?

Gifts to charitable and certain other organizations are deductible by virtue of §2522. In Du Pont v. United States, 97 F. Supp. 944 (D. Del. 1951), in which the court held that a contribution to the National Economic Council was not deductible because the organization did not meet the requirements of §2522, the government allowed one exclusion and the court implied that this allowance was proper. Rev. Rul. 59-57, 1959-1 C.B. 626, states that contributions to political parties are not deductible, but that the $3000 exclusion is applicable. If a contribution to the political party is to finance an electoral campaign, should one exclusion be allowed for each candidate? If the taxpayer contributes to several committees or other groups who are supporting a single candidate, is he entitled to a separate exclusion for each contribution, or must the gifts be amalgamated on the theory that they benefit but a single donee?

8. *Reference.* Cavitch, Obtaining the Gift Tax Exclusion on Gifts in Trust: Drafting and Legislative Suggestions, 51 Mich. L. Rev. 621 (1953).

GILMORE v. COMMISSIONER

213 F.2d 520 (6th Cir. 1954)

Before ALLEN and MCALLISTER, Circuit Judges, and GOURLEY, District Judge.

MCALLISTER, Circuit Judge.

The issue in this case is whether a gift of property in trust for the benefit of minors, providing that the trustees pay the principal and income to the beneficiaries upon their demand, with a further provision permitting the trustees to invest the trust funds in income or non-income producing investments, is a gift of a present interest. . . .

Petitioner made the gifts, of corporate stock, by the creation of trusts for her seven minor grandchildren. The trusts provided that the trustees "*shall pay the principal and all income from the trust estate to* (*the named beneficiary*) *upon demand by the said* (*beneficiary*), and in case of his death this trust will terminate and all of the remaining principal and accumulated income therefrom shall be paid to the estate of the said (beneficiary)." (Emphasis supplied.)

The trust further provided that "All payments of income or distribution of principal to the beneficiary . . . shall be made to such beneficiary in person or upon his personal receipts"; that they should not be grantable, transferable, or otherwise assignable in anticipation of payment thereof, in whole or in part, by the voluntary or involuntary acts of any such beneficiary, or by operation of law, and should not be liable or taken for any obligation of such beneficiary. It was further provided that payments or distributions to an incompetent beneficiary might be made by the trustees for the benefit of such beneficiary in certain desig-

nated ways as in the opinion of the trustees would be most desirable, as noted in the margin.[1]

The Commissioner, in his determination of deficiency, denied the claimed exclusion and determined that the gifts were of future interests on the ground that "Since the beneficiaries at the time of the transfers ranged in ages from one to seven years it is considered that each of the transfers of the trust income and corpus were 'future interests' as defined by the Commissioner." The Tax Court's decision was, however, not based on the minority of the beneficiaries but upon the terms of the trust which the court construed so to limit the beneficiaries' rights, as to compel the conclusion that the gifts involved were of future interests, whether or not the benficiaries were minors.

[Discussion of trustees' power to invest in non-income-producing property omitted; see page 1058 supra.]

The Tax Court appears to have considered that the provision in the trust instrument for using payments of principal or income "directly for the benefit of such beneficiary" gave unqualified power in the discretion of the trustees, to hold the corpus and income in disregard of a direct demand for the payment thereof by a donee. Where a trust authorizes the payment by the trustees, upon demand by the beneficiary, either direct to the beneficiary, to his parent, or other person with whom he resides, or by direct application by the trustee for the benefit of the beneficiary, there is no discretion on the part of the trustee to withhold payment. And again, we come back to the unqualified direction to the trustees to pay the principal or income of the trusts *on demand of the beneficiary*. Kieckhefer v. Commissioner, 7 Cir., 189 F.2d 118, 121, is an authority in point on the issue here presented. There, the donor created a trust for the benefit of his grandson, at that time less than one month of age. The instrument provided for payment to, or application for, the benefit of the beneficiary of so much of the trust income or principal as might be necessary for the education, comfort, and support of the beneficiary, with instructions to accumulate the balance of income for future distribution. It was further provided that the beneficiary was to be entitled to all or any part of the trust estate, free of trust, whenever he, or his legally appointed guardian, made due demand therefor by an instrument in writing. The Tax Court had held that the gift of both income and principal was clearly one of a future interest, and that the right of the beneficiary to demand payment was nugatory since a minor was incapable of making an effective demand. The Court of Appeals reversed, and held the gift to be one of present interest because the beneficiary's right to demand gave him an unconditional right to the present use, possession, or enjoyment of the property. In its decision, the court held that "It is not . . . the use, possession or enjoyment by the beneficiary which marks the dividing line between a present and future interest, but

1 "Payments or distributions to an incompetent beneficiary may be made by the Trustees for the benefit of such beneficiary in such of the following ways as in their opinion shall be most desirable: (a) directly to such beneficiary; (b) to the duly qualified legal representative or representatives of such beneficiary; (c) to some near relative or friend of such beneficiary; or (d) by the Trustees using payment directly for the benefit of such beneficiary. Distributions of the Trust Estate, or any share thereof, may be made in investments at the fair market value thereof and cash, or either, and in such proportions thereof as the Trustees shall deem to be most equitable.

"*Incompetent Persons.* A person shall be deemed 'incompetent' for the purposes of this agreement if he or she shall be under legal disability declared or adjudicated by a court of competent jurisdiction, or if he or she shall be incapacitated to such extent as, in the Trustees' opinion, shall make it impossible or impracticable for such person to give prompt and intelligent consideration to business matters. The Trustees may require, accept and act upon such evidence of the competence or incompetence of any person as the Trustees shall deem appropriate and reliable without liability by reason thereof."

it is the right conferred upon the beneficiary to such use, possession or enjoyment." It is the right given to the donee, in the trust instrument, to use, possess, or enjoy, and not the capacity of the donee, which determines whether the gift is one of present or future interest. Fondren v. Commissioner, 324 U.S. 18; United States v. Pelzer, 312 U.S. 399.

The government, however, submits that even though the beneficiaries were adults, the gifts in this case would be contingent to them for the same reason they would be contingent to the infant beneficiaries, and that no beneficiary, adult or infant, could make an effective demand that the trustees pay him the entire estate at any time — in spite of the fact that the trust instrument expressly provides for such payment on demand. We are unable to concur in such a view, so obviously contrary to the donor's intention and so clearly contrary to the language of the trust instrument.

The Tax Court further decided that the gifts were not of present interest because the trust instrument provides that the trustees may determine, in their own discretion, whether a beneficiary is incapacitated to such an extent as to make it impossible for him to give prompt and intelligent consideration to business matters, and in such case, they were empowered to make payments at their sole discretion, among other ways, by using such payments for the benefit of the beneficiary. The Tax Court, therefore, held that the beneficiary's right to present enjoyment of income or principal was contingent on the mere whim of the trustees.

With regard to incompetence, the provision in the trust instrument is that a person shall be deemed "incompetent," for the purposes of the trust, if he shall be under legal disability, declared or adjudicated by a court of competent jurisdiction, *or if he shall be incapacitated* to such extent as, in the trustees' opinion, shall make it impossible or impracticable for him to give prompt and intelligent consideration to business matters, and that the trustees may require, accept, and act upon such evidence of the competence or incompetence of any person that the trustees shall deem appropriate and reliable. This certainly does not mean that the trustees may determine, by their mere whim, that a donee is incompetent, because incapacitated. "Incapacitated" is a strong word, and, according to the purport of the trust instrument, a conclusion by the trustees that a beneficiary is incompetent and incapacitated envisages reliance on trustworthy evidence. The discretion of the trustees in this regard is the discretion of reasonable men acting as trustees. They must act in good faith. They cannot act on arbitrary whim; and any such action could be remedied by a court of equity on grounds of betrayal of trust and abuse of discretion.

In accordance with the foregoing, the decision of the Tax Court is reversed and the deficiency expunged.

BRIGGS v. COMMISSIONER

34 T.C. 1132 (1960)

TIETJENS, Judge: The petitioner contests a deficiency of $5,255.81 in gift tax for 1954, based on a determination by the Commissioner that gifts of stock made by petitioner to nine minor donees under guardianship were gifts of future interests in property rather than present interests. . . .

The gifts in question consisted of shares of corporate stock of the Outboard Marine & Manufacturing Company and were made by the petitioner and her husband by deed of gift to already-appointed guardians of the minor donees. During 1954 the minor donees resided in California and Illinois with their respective parents.

Each gift made to the children in California was made "subject to terms and conditions of the order of the Superior Court of Los Angeles County in the matter of your guardianship" made by the court authorizing the donee's guardian to accept the gifts. The gift made to the minor donee residing in Illinois was made subject to the same conditions, specified in the deed of gift itself. The conditions attached to each gift were stated as follows:

1. That each gift is made subject to all gift taxes thereon. The Donee shall pay all such taxes imposed upon the Donor (Stephen F. Briggs or Beatrice B. Briggs, as the case may be) by reason of such gift, or shall reimburse the Donor therefor, without interest. Such payment or reimbursement shall be made only out of the corpus of the donated property, or out of other property of the Donee, and in no case out of income from the donated property.

2. That your Guardian shall be authorized but not required to use or expend any part of the donated property or of the income therefrom, or both, for your support, maintenance and education; any income not used for the purposes mentioned to be invested for your benefit.

3. That your Guardian shall in no case be required to convert the donated shares of stock into any other form of holding, but is authorized to retain such shares as long as in your Guardian's judgment retention is in the best interest of yourself, as Donee.

The parents of each beneficiary were at the time of the gift and thereafter fully willing and able to provide adequately for the maintenance, education, and support of each of the beneficiaries. Petitioner was aware of this fact and expected that state of affairs to continue, but she recognized the possibility that future needs or misfortunes might arise which could alter that state of affairs.

At the time of the gifts in question and thereafter during the minority of the minor donees, the respective fathers of each of the donees served as their respective guardians, duly appointed by an appropriate court, and accounts and reports of each of the guardianship estates have been filed and approved by these courts without any appeal from any of these accounts.

These accounts and reports indicate that dividends from the donated stock were received by the guardians and that disbursements were made from each of the guardianship estates, including cash distributions to the minors themselves (sometimes referred to as "allowances"), payments of the minors' income and gift taxes, and various types of insurance premiums, and in some cases, payments of private school tuition and expenses, dental expenses, airplane fare and bus fare, clothing and other wearing apparel, summer camp, court costs, automobiles, purchase of investments, bank charges, and miscellaneous expenses not otherwise identified in the accounts.

When any of the minors reached age 21, his or her guardianship was terminated and the estate was delivered to him or her, including the gift property here involved. . . .

The Commissioner's argument is summarized as follows: The California law, as well as that of Illinois, prevents parents of minors (who in this case are also legal guardians) from using the estates of their minor children or the income therefrom for the support, maintenance, and education of their children, unless the estates of the parents are insufficient to support the children in accordance with their station in life. In other words, the Commissioner argues, the minor donees did not at the time of the gifts "receive the unqualified and immediate right *then* to the use and enjoyment . . . of the donated property and the income therefrom."

We think the Commissioner's argument cuts too deep. The so-called condition, set forth as paragraph 2 above, to which our attention is directed, is not, in our opinion, a restriction on the use of the gifts themselves or their income

which transforms what otherwise would be a gift of a present interest in the property into a future interest. The purpose of the condition was just what the petitioner contends it was; i.e., to remove the restriction imposed by State law, which permits the use of a minor's estate for the minor's support, maintenance, and education only if the parents are unable themselves to provide for such needs from their own estates. See Cal. Prob. Code secs. 1502, 1503, 1504, and Ill. Ann. Stat. ch. 68, sec. 52(a) (Smith-Hurd). It was a provision designed to free the guardians from these limitations of State law and not a restriction on the present use of the gift property imposed by the donor. As a matter of fact, the provision had the effect of *removing* a limitation and not of *imposing* one on the immediate use of the property for the minors' benefit.

That the guardians so interpreted the "condition" of the gifts is shown by the character of the expenditures made and reports filed with and approved by the appropriate courts. They ranged from allowances, to automobiles, clothing, airplane and bus fare, and tuition. And this without any showing that these were items "more expensive than his father can reasonably afford" which would justify dipping into the minor's estate under California Probate Code section 1504.

Some of the difficulty in this case arises from the fact that the donees are infants represented by guardians. This, however, does not necessarily convert the gift of a present interest into a future interest. As indicated in the Commissioner's brief: It was stated in Fondren v. Commissioner, 324 U.S. 499 (1944), that "The statute in this respect purports to make no distinction between gifts to minors and gifts to adults. If there is deferment in either case the exemption is denied." In Revenue Ruling 54-400, 1954-2 C.B. 319, it was stated that:

> An *unqualified* and *unrestricted* gift to a minor, *with* or *without* the appointment of a legal guardian, is a gift of a present interest; and disabilities placed upon minors by State statutes should not be considered decisive in determining whether such donees have the immediate enjoyment of the property or the income therefrom within the purport of the Federal gift tax law. . . . In the case of an *outright* and *unrestricted* gift to a minor, the mere existence or nonexistence of a legal guardianship does not of itself raise the question whether the gift is of a future interest. . . . It is only where delivery of the property to the guardian of a minor *is accompanied by limitations upon the present use and enjoyment of the property by the donee, by way of a trust or otherwise, that the question of a future interest arises.* . . . [Emphasis supplied.]

As we have indicated above the donor in this case imposed no restrictions or limitations on the present use and enjoyment of the property by the donees. The only limitations on the use of the property were those imposed by State law and it has been recognized, both in Revenue Ruling 54-400, supra, and case law, that such limitations are not decisive and do not make a gift to a minor under guardianship a future interest.

In United States v. Baker, 236 F.2d 317, 320 (C.A. 4, 1956) it was stated:

> The trust agreements with which we are concerned here created no barriers to the present enjoyment by the infants of the trust fund beyond those which are established by the laws of North Carolina. Indeed, the agreements actually remove certain of these barriers, since if a guardian were to be appointed his use of the trust funds for the benefit of the infant must be subject to approval by the court having jurisdiction of the subject matter; whereas, by the express provisions of these trust agreements, the trustee, although empowered to deal with the funds as if he were guardian of the infants, is not required to secure approval of his acts by any court. As was said by the Supreme Court in the case of Fondren v. Commissioner, infra [324 U.S. 18, (1945)], "the crucial thing" in determining whether a gift is one of a future interest in property "is postponement of enjoyment." Here the right of the beneficiaries to present enjoyment of both the corpus and the income is not different from what it would be if the gifts had been made directly to each

of them, or to a guardian for their benefit. There is no magic in mere words. These gifts to a trustee, since they conferred on the beneficiaries the same right to present enjoyment which they would have had if the gifts had been made to a guardian for them, must be judged by the same standard as that applied to gifts made to a guardian.

And in Kieckhefer v. Commissioner, 189 F.2d 118 (C.A. 7, 1951) reversing 15 T.C. 111 (1950), the court said:

> As heretofore shown, the fallaciousness of the Commissioner's contention is the failure to distinguish between restrictions and contingencies imposed by the donor (in this case the trust instrument), and such restrictions and contingencies as are due to disabilities always incident to and associated with minors and other incompetents. As to the former, it is authoritatively settled that a gift *upon which the donor imposes such conditions or restrictions* is of a future interest. In the latter, such restrictions as exist are imposed by law due to the fact that the beneficiary is incapable of acting on his own. It is our view, and we so hold, that such restrictions do not transform what otherwise would be a gift of present interest to one of future interest. [Emphasis supplied.]

See also Commissioner v. Sharp, 153 F.2d 163 (C.A. 9), affirming 3 T.C. 1062.

It is to be noted that the gifts here were made directly to minors under guardianship. No trust or other person or entity was interposed between the donor and the guardian who stood in the shoes of the minor donee. This was not the case in Stifel v. Commissioner, 197 F.2d 107 (C.A. 2), affirming 17 T.C. 647 and Abraham M. Katz, 27 T.C. 783, where a result different from the result here was reached. However, in both of those cases the court indicated that had a guardian been appointed to exercise the children's rights or, "Had outright gifts been made directly to the beneficiaries or to guardians acting for them there would be no question that the transfers were of present interests." Abraham Katz, supra at 785. That, as we see it, is the case here.

The Commissioner further argues that the gifts were of future interests because the right of the donees to receive the stock or the income therefrom depended upon the exercise of discretion by the guardian. There is no merit in this contention. The only discretion lodged in the guardian was that provided for by State law — and the donor here had attempted to broaden that discretion. Whatever restrictions there were were those imposed by State law on *all* guardians. They were not imposed by the donor. If this argument of the Commissioner were carried through it appears that it would be impossible to make a gift of a present interest to a minor under guardianship, and that is not the law as we understand it.

The Commissioner further contends that petitioner intended these gifts to be of future interests and points to the fact that in making similar gifts of stock in other years no such "conditions" were attached. We conclude from the record, however, that the so-called conditions were inserted from an abundance of caution for the purpose of removing State law restrictions and making it unnecessary for the guardians to obtain prior court approval before making the expenditures which were made from the donated funds. We see no intent to give future interests rather than present.

We hold that the gifts here involved were gifts of present interests in property.

Reviewed by the Court.

NOTE

Other cases. On facts similar to the *Gilmore* case, the exclusion was denied on the ground that the minor benficiaries "acquired only 'future interests,' not subject to immediate capture," because at the time the gift was made no guardian was named in the instrument or had been appointed by the appropriate court to exercise the power of

termination on their behalf. Moreover, the minors were under the age of 14 and could not, under applicable state law, apply for the appointment of a guardian on their own. Stifel v. Commissioner, 197 F.2d 107 (2d Cir. 1952).

Is this view rejected by Rev. Rul. 54-400, quoted by the court in the *Briggs* case?

See Perkins v. Commissioner, 27 T.C. 601 (1957), where the Internal Revenue Service denied the gift tax exclusion to a trust under which the minor beneficiary, his parents, or a guardian (if one was appointed) could demand the corpus and accumulated income at any time. It is not clear whether the Service took the position that Rev. Rul. 54-400 is inapplicable to gifts in trust, or based its disallowance on the fact that in the particular case the parents' wealth made an exercise of the power highly unlikely or on some other circumstance. The Tax Court held that the $3000 exclusion was applicable (though suggesting that if the power to terminate the trust had been vested *solely* in the minor beneficiary and a nonexistent guardian, it would follow *Stifel* rather than *Gilmore*); one judge dissented.

If the taxpayer gives an electric train or an imported sports car to his son, warning that it will be taken away if he misbehaves, has he made a gift, or a revocable transfer? If a gift, is the exclusion allowable?

HERR v. COMMISSIONER

35 T.C. 732 (1961)

RAUM, Judge: In issue are gift tax deficiencies determined against petitioners, husband and wife, for 1955. The facts have been stipulated. The question for decision is whether each petitioner is entitled to a $3,000 exclusion under section 2503 of the 1954 Code in respect of a 1955 transfer to each of four trusts established for the benefit of petitioners' minor grandchildren in 1954. The transfers in question were made by petitioner Robert F. Herr; his wife is involved herein only because she consented in her gift tax return to have one-half of her husband's gifts treated as having been made by her.

On August 23, 1954, the husband, referred to as the settlor, created four trusts, each by separate declaration of trust for the primary benefit of a different minor grandchild. The four declarations of trust were identical except for the designation, by name and sex, of the grandchild who was to constitute the primary beneficiary of the particular trust. Relevant provisions of one of the trusts are as follows:

"FIRST: Settlor hereby declares that he holds 425 shares of common stock of Philco Corporation (which he is at this time transferring to himself as Trustee hereunder), IN TRUST, as follows:

"(a) To pay the net income to Settlor's granddaughter, FRANCEAN H. HALLINGER, until her arrival at age thirty (30) and then to pay over to her the principal.

"(b) If Settlor's said granddaughter shall die before reaching age thirty (30) the principal shall be paid

"(1) To her surviving issue, per stirpes, or, if she leaves no surviving issue

"(2) In equal shares to her siblings living at her death and to the issue of any sibling then deceased, such issue to take, per stirpes, the share the deceased sibling would have received if living.

". . .

"THIRD: Trustee shall retain any share of income or principal payable to a minor, together with any income accruing thereon, and may invest and reinvest the same as in the case of other property comprising the principal of this trust and may apply so much of such income and principal as he deems necessary directly for the maintenance, support and education of the minor, or may pay the same to any person selected by him to disburse it, whose receipt shall be a com-

plete acquittance to Trustee therefor, without in any case any order of court or the intervention of any guardian. All unexpended sums of accumulated income and principal shall be paid to the minor at his or her majority or to his or her estate if the minor dies before majority."

On January 19, 1955, petitioner Robert F. Herr added to the corpora of the trusts by transferring to each trust certain corporate stock having a then fair market value of $16,070.31. The primary beneficiaries were then 6, 4, 3, and 2 years of age, respectively. In the case of each such transfer, the present worth at the date of the transfer of the right to receive the income from the transferred stock during the minority of the primary beneficiary was in excess of $6,000.

In their gift tax returns for 1955 each petitioner claimed four annual exclusions of $3,000 each. The Commissioner disallowed the exclusion on the ground that "Transfers to donor's four grandchildren are deemed to have been gifts of future interests for which no exclusions are allowed. Section 2503, Internal Revenue Code of 1954."

We dispose first of the contention that petitioners are entitled to the exclusions under section 2503(b) apart from subsection (c). Subsection (b), to the extent that it is relevant here, was derived from section 1003(b)(3) of the 1939 Code, and the decisions relating to the latter provisions are pertinent.

Plainly, as recognized by petitioners, the gifts of corpus represented future interests and could not comply with the requirements for the exclusion. However, a gift may be separated into its component parts one of which may qualify as a present interest so as to bring the statutory exclusion into play. Fondren v. Commissioner, 324 U.S. 18, 21. And petitioners contend that the income interest up to the majority of each grandchild is not disqualified as a "future interest". We disagree.

As appears from paragraph THIRD of each trust instrument, the trustee is directed to "retain any share of income or principal payable to a minor, . . . and may invest and reinvest the same . . . and may apply so much of such income and principal as he deems necessary directly for the maintenance, support and education of the minor . . . All unexpended sums . . . shall be paid to the minor at his or her majority . . ." That this provision requires the income interest in question to be classified as a future interest is made clear by Commissioner v. Disston, 325 U.S. 442, where the Court said (pp. 448-449):

"The language of the trust instruments directs that the income be accumulated during minority. The subsequent provision for payments for maintenance and support may be said to indicate a departure from the policy of accumulation only when necessary, in the reasonable discretion of the trustees. If that is the appropriate interpretation of the trust instruments, then little difference from the Fondren case is involved. Even in its practical working, the trustees did not find the necessary prerequisites for a steady application of all or any ascertainable part of the income for education, support and maintenance.

"But, even though the trustees were under a duty to apply the income for support, irrespective of outside sources of revenue, there is always the question how much, if any, of the income can actually be applied for the permitted purposes. The existence of a duty so to apply the income gives no clue to the amount that will be needed for that purpose, or the requirements for maintenance, education and support that were foreseeable at the time the gifts were made. In the absence of some indication from the face of the trust or surrounding circumstances that a steady flow of some ascertainable portion of income to the minor would be required, there is no basis for a conclusion that there is a gift of anything other than for the future. . . ."

To the same effect is Hessenbruch v. Commissioner, 178 F.2d 785 (C.A. 3).

Accordingly, we hold that petitioner is not entitled to the claimed exclusions under subsection (b) [of §2503] without the benefit of subsection (c). We therefore pass to the question whether subsection (c) is operative to allow the exemption under (b) which would not otherwise be available under the provisions of (b) standing alone.

Subsection (c) became part of our revenue law for the first time in 1954, and the legislative history discloses that it was in response to the difficulties arising in connection with the classification of a gift for the benefit of a minor as a present interest. H. Rept. No. 1337, 83d Cong., 2d Sess., p. 93; S. Rept. No. 1662, 83d Cong., 2d Sess., p. 127. However, as the foregoing report of the House Committee points out in its "Detailed Discussion of the Technical Provisions of the Bill" (p. A 322), the new provision merely "partially relaxes the 'future interest' restriction contained in subsection (b), in the case of gifts to minors, by providing a specific type of gift for which the exclusion will be allowed," and the question before us is whether the gifts herein are within the range of the new provision.

A superficial reading of subsection (c) would appear to exclude the present gifts from its coverage, for it requires that "the property and income therefrom" may be expended by or for the benefit of the minor prior to majority and to the extent not so expended will pass to the minor at 21 or to his estate or his appointee in the event of death before 21. And since the corpus of each trust which generates the income here in issue is payable to the beneficiary, pursuant to paragraph FIRST, only upon attaining the age of 30 (with provision for other disposition in the event of prior death), it may be argued, as is done by the Government, that subsection (c) is inapplicable. That argument would be sound if the term "property" were treated as the equivalent of the trust corpus in this case. If one were to consider only the naked words of the statute, that interpretation would be a reasonable one. However, we are satisfied, upon examining the gift tax provisions generally as they have been judicially interpreted, that such is not in accord with the intention of Congress.

As noted above, the Supreme Court has expressly recognized that a gift may be separated into component parts one of which may qualify as a present interest under the statute. Fondren v. Commissioner, 324 U.S. 18, 21; Commissioner v. Disston, 325 U.S. 442, 447. We think it highly unlikely that the draftsmen of the pertinent provisions of the 1954 Code were unaware of these decisions which loomed so large in so limited a field. Certainly, if the donor had made a gift of income only to each grandchild subject to the conditions set forth in paragraph THIRD, it would comply fully with the requirements of subsection (c), and the Government does not contend otherwise. Cf. Jacob Konner, 35 T.C. 727, decided this day.[1] The word "property" as related to that situation would refer to the entire subject of the gift. And it is difficult to see why such a gift should not similarly qualify as a present interest merely because it is coupled together with two other components (income from twenty-one to thirty and corpus at thirty) which are future interests. For, both the *Fondren* and *Disston* cases have made it clear that one component may satisfy the conditions for a present interest while another fails to do so. Accordingly, it is our opinion that when considered in this context Congress intended the word "property" to mean, not the corpus of a trust, but rather the totality of elements that go to make up the entire gift that is being considered for classification as a present interest. In this case the totality of those elements consists of all the income up to majority. In the aggregate all

[1] In the *Konner* case, the Commissioner explicitly treated a series of income payments for a maximum period of approximately 10 years as "property" within the meaning of section 2503(c) but contended that they failed to satisfy the requirements of those provisions for reasons that are not germane here.

such payments constitute the "property" in question, and since this "property" and the accretions thereto must be expended for the benefit of the donee prior to majority or paid over to the donee at twenty-one or to the donee's estate or appointee in the event of death prior to twenty-one, the requirements of subsection (c) are fully met. Otherwise, Congress would have intended the incongruous result of classifying such income payments up to majority as a present interest when not accompanied by a gift of corpus but as a future interest when the gift thereof is made in conjunction with a gift of corpus that fails to qualify. We cannot believe that it intended any such strange distinction, and we hold that the gifts of income up to majority satisfy the requirements of subsection (c).

NOTE

1. The *Herr* case on appeal. The decision of the Tax Court in *Herr* was affirmed on appeal, 303 F.2d 780 (3d Cir. 1962). The appellate court said, in part:

> To bring out our problem here, let us suppose this case: A settlor creates a trust, the income of which is to go to M, a minor, until M is twenty-one. When M is twenty-one the corpus of the trust is to be given to X. Can there be any doubt that in this case the income of the trust is a "present interest" to M as he receives the payments year after year? If we add an additional provision that the minor is to receive, until he is tweny-one, so much of the income as is necessary for his support and that any undistributed income and interest thereon is to go to him at twenty-one, does he not still have a present interest?
>
> If this is right, does it change the situation, if instead of the corpus going to X when M is twenty-one, it is to go to M when he is thirty? That is this case. We think the Tax Court was right in looking at this problem in the light of division of interest in the thing (corpus) in the way it did. The right to income during minority is a present interest; the right to income and principal after minority are future interests.
>
> If that conclusion is not correct we have a very incongruous set of results in the distinction between the right of a stranger to receive the future interest and the right to receive the future interest when it is to go to the one entitled to the income during his minority. [303 F.2d at 782.]

2. *Other aspects of §2503(c).* In the *Herr* case, the trustee was authorized to apply "so much of such income and principal as he deems neceessary . . . for the maintenance, support and education of the minor." What if this power was subordinate to a provision of state law (see the *Briggs* case, supra) forbidding the use of trust funds to support the trustee's minor children unless he is unable to support them with his own funds? Would §2503(c) apply if the trustee may use trust income only for the minor's medical expenses, college tuition, or extraordinary needs? According to Regs. §25.2503-4(b)(1), the trustee may have discretion over the amounts and the purposes of expenditures "provided there are no substantial restrictions under the terms of the trust instrument on the exercise of such discretion." What about restrictions on the timing of expenditures, e.g., a power to make expenditures only when the beneficiary reaches the age of 18?

In the *Herr* case, the trustee was authorized to spend both income and corpus for the beneficiary's benefit. Would the result have been the same if he had been denied the power to invade principal? See Weller v. Commissioner, 38 T.C. 790, 807-810 (1962) (non-acquiescence).

Would §2503(c)(2)(B) be satisfied if the principal and expended income are payable as the minor may appoint, if he dies before 21, but in default of appointment are to be paid to specified persons rather than to his estate? Note that in such a case the property would go to persons designated by the grantor if the minor dies before he is old enough to exercise a power of appointment. Does §2503(c)(2)(B) require, in other words, that the property must go either to the minor's estate or to persons whom he (rather than the grantor) designates? Even if the property is so payable, it will go to the child's intestate successors if he dies before he is old enough to make a will or exercise a power of

appointment; and he cannot select his intestate successors. See Regs. §25.2503-4; Heath v. Commissioner, 34 T.C. 587 (1960); Clinard v. Commissioner, 40 T.C. 878 (1963) (provision for distribution to minor's "next of kin"; held, not the equivalent of payment to his "estate").

In Rev. Rul. 60-218, 1960-1 C.B. 378, the Service ruled that a trust for a minor does not meet the requirements of §2503(c) if the trust instrument provides that the donee may compel immediate distribution on attaining the age of 21 or elect to extend the trust, in which event he will receive a distribution of one third of the corpus at 25, one third at 29, and one third at 33. In the absence of an election by the minor the trust is to continue on its own terms. The ruling provides, in part:

> The purpose of section 2503(c) of the Code is to allow the exclusion provided for in section 2503(b) if the property involved in the transfer to the minor is, under the provisions of the instrument of transfer, to pass to him as absolute owner when he reaches 21. The provisions of section 25.2503-4(b)(2) of the regulations are designed to permit the extension of the term of the trust by the donee upon such conditions as he may freely choose. This, of course, includes the right in the donee to extend the term of the trust upon conditions therein set forth by the donor but, in any event, the extension must be an act of the donee as absolute owner of the property.
>
> The provisions of the trust will not be considered as conferring upon the donee absolute ownership of the property upon his reaching the age of 21 if, under such provisions, he is required to perform some positive act upon reaching that age in order to receive the property. He must be given the unequivocal and unconditional right to receive the property without any necessity for affirmative action on his part. A power conferred, as in the instant case, upon a donee to require immediate distribution of the property to him upon attaining the age of 21 years does not meet the statutory requirement that the property must pass to him upon attaining the age of 21 years.

3. *Custodial arrangements.* It may be impracticable to register securities or other property in the name of a minor because banks and corporate transfer agents usually do not want to have to make decisions about the minor's competency or fear that instructions by the minor or his parents may be disaffirmed when the minor reaches the age of 21. Can the property be registered in the name of the parent or some other adult as "trustee," "custodian," etc., if no formal restrictions are placed on the minor's right to present use and enjoyment of the property? See Rev. Rul. 55-469, 1955-2 C.B. 519, stating that no trust is created where stock given to a grandchild is registered in the names of the minor's parents "merely because the State law does not permit securities to be registered in the names of minors." The ruling is concerned with an income tax question and expresses no opinion on the applicability of the $3000 gift tax exclusion.

A number of states have adopted statutes permitting stock transferred to a minor to be registered in the name of a "custodian" who is authorized to apply the principal and income to the support, maintenance, education, and general use and benefit of the minor, in such manner, at such time, and to such extent as the custodian deems suitable and proper. The unexpended property is to be delivered or paid to the minor at 21; if he dies before then, the property goes to his estate. Rev. Rul. 56-86, 1956-1 C.B. 449, rules that a transfer under a statute of this type is a completed gift and will qualify for the $3000 exclusion of §2503(b); see also Rev. Rul. 59-357, 1959-2 C.B. 212 (same principles applicable to Uniform Gifts to Minors Act and Model Gift of Securities to Minors Act). Does the exclusion apply because the gift qualifies under §2503(c)? If the transfer is made by the father to himself as custodian, why is the transfer a completed gift rather than a revocable transfer (see Burnet v. Guggenheim, supra p. 1007), in view of the custodian's power to apply the property to the minor's support, maintenance, and education — i.e., to expenses for which he is legally responsible? See Rev. Rul. 56-484, supra page 386.

4. *Relation of §2503(c) to non-qualifying gifts to minors.* Section 2503(c) describes "a certain type" of gift to a minor that will qualify for the gift tax exclusion, according to the Senate Report on the 1954 Code. S. Rept. No. 1622, 83d Cong., 2d Sess. 479.

This is interpreted by the Regulations to mean that §2503(c) is not exclusive. Regs. §25.2503-4(c) (a non-qualifying gift may be either a present or a future interest).

What are the meaning and effect of the following statement in the same report? "Where a child's guardian who has control over gifts to a child, is personally responsible for the support of a child, since he must provide for the current needs of the child, it would appear that a valid gift could only be for a child's future benefit." S. Rept., p. 127. In the *Stifel* case, supra, the court indicated that had a guardian been named or appointed to exercise the power to terminate the trust there involved, it "would then seem to be proper to consider the actual facts as to the father's influence on the guardian appointed."

5. *References.* Ehrlich, The Effective Use of Support Trusts: Trusts for Minors, Custodian Statutes, Gifts of Future Interests, 19 N.Y.U. Inst. on Fed. Taxation 729 (1961); Brandis, Gifts to Minors, 1957 Tulane Tax Inst. 178; Caplin, How to Treat Gifts to Minors, 13 N.Y.U. Inst. on Fed. Taxation 193 (1955); Note, Recent Legislation to Facilitate Gifts of Securities to Minors, 69 Harv. L. Rev. 1476 (1956); Rogers, Some Practical Considerations in Gifts to Minors, 20 Fordham L. Rev. 233 (1951).

SECTION G. COMPUTATION OF THE GIFT TAX

In addition to the annual exclusion for each donee, the donor is allowed a lifetime "specific exemption" of $30,000 (originally $50,000, reduced to $40,000 as of 1936 and to $30,000 as of 1943) to be taken in the year or years chosen by him. He may also deduct gifts to charities and other nonprofit institutions that qualify under §2522(a); in the case of nonresident aliens, however, only gifts to domestic institutions qualify. The tax schedule is cumulative, i.e., the tax bracket for the current year's gifts is governed by the aggregate sum of the net gifts in 1932 and all succeeding years. A tax is first computed (at current rates) on the aggregate sum of the net gifts for 1932 and subsequent years including the current year. Then a tax is computed on the same amount exclusive of the current year's net gifts. The difference is the tax due on the current year's gifts.

A gift of community property is treated as a gift of one half by the wife and one half by the husband, so that each spouse is entitled to a $3000 annual exclusion for each donee and to his or her own $30,000 lifetime exemption. For discussion of the analogous "split gift" and "marital deduction" provisions which apply to gifts of common law property by married couples, see page 1110 infra.

An example from the Regulations may clarify the computation procedure (Regs §25.2502-1(c)):

Example (2). A donor makes gifts (other than gifts of future interests in property) during the calendar year 1955 of $30,000 to A and $33,000 to B. Two exclusions of $3,000 each are allowable, in accordance with the provisions of section 2503(b), which results in included gifts for 1955 of $57,000. Specific exemption was claimed and allowed in a total amount of $50,000 in the donor's gift tax returns for the calendar years 1934 and 1935 so there remains no specific exemption available for the donor to claim for 1955. The total amount of gifts made by the donor during preceding years, after excluding $5,000 for each donee for each calendar year in accordance with the provisions of section 1003(b)(1) of the 1939 Code, is computed as follows:

Calendar year 1934	$120,000
Calendar year 1935	25,000
Total amount of included gifts for preceding calendar years	$145,000

The aggregate sum of the taxable gifts for preceding calendar years is $115,000, which is determined by deducting a specific exemption of $30,000 from $145,000, the total amount of included gifts for preceding calendar years. The deduction from the 1934 and 1935 gifts for the specific exemption cannot exceed $30,000 for purposes of computing the tax on the 1955 gifts even though a specific exemption in a total amount of

$50,000 was allowed in computing the donor's gift tax liability for 1934 and 1935. See paragraph (b) of §25.2504-1. The computation of the tax for the calendar year 1955 (following the step set forth in paragraph (a) of this section) is shown below:

(1) Amount of taxable gifts for year	$ 57,000
(2) Total amount of taxable gifts for preceding years	115,000
(3) Total taxable gifts	172,000
(4) Tax computed on item 3 (in accordance with rate schedule in paragraph (b))	31,725
(5) Tax computed on item 2 (using same rate schedule)	18,900
(6) Tax for year 1955 (item 4 minus item 5)	12,825

In its report on the Revenue Act of 1932, the House Ways and Means Committee explained the theory of the computation as follows:

The computation of the tax payable each year involves three operations, namely: (1) A computation of the tax at the graduated rates on all gifts (with certain express exceptions) made after the enactment of this Act, including gifts made in the current calendar year; (2) a computation of the tax at the graduated rates on the gifts made in the prior year or years; (3) the subtraction of the result of the second computation from that of the first. This computation results in a tax imposed on a cumulative basis. In short, the design is to impose a tax which measurably approaches the estate tax which would have been payable on the donor's death had the gifts not been made and the property given had constituted his estate at his death. The tax will reach gifts not reached, for one reason or another, by the estate tax.

The gift tax will supplement both the estate tax and the income tax. It will tend to reduce the incentive to make gifts in order that distribution of future income from the donated property may be to a number of persons with the result that the taxes imposed by the higher brackets of the income tax law are avoided. It will also tend to discourage transfers for the purpose of avoiding the estate tax.

An objection urged against the former gift tax (that imposed by the Revenue Act of 1924) was that it might be readily evaded by spreading the gifts over a period of years. Under that tax a person could in each year make gifts equal to the deductions, including the specific exemption, and thus escape the tax entirely. Where taxable gifts were spread over a number of years, the combined effect of the annual specific exemption and of the graduated rates resulted in the aggregate of the gift taxes imposed being much less than what the tax would have been had all the gifts been made in a single year. If a gift tax is to yield a material revenue it is necessary that it be imposed on a cumulative basis as is the proposed tax. Since the gift tax is an adjunct of the estate tax which is not restricted to transfers made within a single year, an effective gift tax must give consideration, so far as the rate of tax is concerned, to transfers made in prior years.

The theory upon which the gift tax is based is that the rate of tax is measured by all gifts made after the enactment of the bill. This scheme is adopted in order to tax gifts made over a period of years at the same rate as if they had all been made within one year. For a more effective administration and to secure prompt collection of the revenues, the bill provides that the tax shall be computed and collected annually. [H. R. Rept. No. 708, 72d Cong., 1st Sess., reprinted in 1939-1 C.B. (Part 2) 457, 477.]

NOTE

1. *Effect of rate changes.* In the computation above, the amount of $18,900 (line 5) representing a tax on the gifts for preceding years is not the amount *actually* paid in 1934 and 1935. The discrepancy results from the fact that when tax was paid for those years, the specific exemption was $50,000; moreover, the rates were lower and have been raised several times in the intervening years.

2. *Adjustment for errors in prior years.* What would be the result if the 1934 and

1935 gifts in the foregoing example had consisted of future interests in property and the donor had (innocently) taken exclusions of $5,000 each with respect to these gifts? Section 6501(a) provides that ordinarily the tax "shall be assessed within 3 years after the return was filed . . . and no proceeding in court without assessment for the collection of such tax shall be begun after the expiration of such period." (The period is extended to 6 years by §6501(e)(2) if items in excess of 25 per cent of the total amount of gifts shown on the return are omitted, and §6501(c) provides that there is no limit on an assessment if no return is filed or if a false return is filed.) It has been held that the running of the statute of limitations does not prevent a denial of the $5,000 exclusion to the 1934 and 1935 gifts in computing the tax liability for 1943. Commissioner v. Disston, 325 U.S. 442 (1945).

A taxpayer made transfers in 1943 that he did not report, erroneously believing that they were not subject to gift tax. He made taxable transfers in 1947, claiming for that year the entire specific exemption of $30,000. On discovering his 1943 error, he filed a return for that year, claiming the $30,000 specific exemption, and an amended return for 1947, eliminating the specific exemption. May he do so? Richardson v. Commissioner, 126 F.2d 562 (2d Cir. 1942) (amendment allowed where failure to take exemption resulted from honest mistake and it was likely that donor would have claimed the exemption in earlier year except for his mistake). What advantage would the taxpayer gain from the amendment? See also Ingalls v. Commissioner, 40 T.C. 751 (1963) (specific exemption not restored when gift was included in gross estate of spouse).

If the donor overvalued his gifts in earlier years and therefore exhausted his specific exemption unnecessarily, it has been held that he may later correct the overvaluation in computing the amount of the specific exemption left for use in subsequent years. Schuhmacher v. Commissioner, 8 T.C. 453 (1947); see also Lockard v. Commissioner, supra p. 1017. Can this decision be reconciled with the statutory injunction that the amount of the specific exemption is $30,000 "less the aggregate of the amounts claimed and allowed as specific exemption" in prior years, §2521? See §2504(c), enacted in 1954, under which the valuation used in computing the tax for a prior year is carried forward, if the statute of limitations has run and a tax was assessed or paid for the prior year.

CHAPTER 12

The Gross Estate: Property Owned by the Decedent at Death

SECTION A. INTRODUCTORY

In New York Trust Co. v. Eisner, 256 U.S. 345 (1921), the federal estate tax was attacked "as an unconstitutional interference with the rights of the states to regulate descent and distribution and as a direct tax not apportioned as the Constitution requires." The Court, through Mr. Justice Holmes, answered:

> The statement of the constitutional objections urged imports on its face a distinction that, if correct, evidently hitherto has escaped this Court. See United States v. Field, 255 U.S. 257. It is admitted, as since Knowlton v. Moore, 178 U.S. 41, it has to be, that the United States has power to tax legacies, but it is said that [the estate] tax is cast upon a transfer while it is being effectuated by the State itself and therefore is an intrusion upon its processes, whereas a legacy [i.e., inheritance] tax is not imposed until the process is complete. An analogy is sought in the difference between the attempt of a State to tax commerce among the States and its right after the goods have become mingled with the general stock in the State. A consideration of the parallel is enough to detect the fallacy. A tax that was directed solely against goods imported into the State and that was determined by the fact of importation would be no better after the goods were at rest in the State than before. It would be as much an interference with commerce in one case as in the other. Darnell & Son Co. v. Memphis, 208 U.S. 113. Welton v. Missouri, 91 U.S. 275. Conversely if a tax on the property distributed by the laws of a State, determined by the fact that distribution has been accomplished, is valid, a tax determined by the fact that distribution is about to begin is no greater interference and is equally good.
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> Knowlton v. Moore, 178 U.S. 41, dealt, it is true, with a legacy tax. But the tax was met with the same objection; that it usurped or interfered with the exercise of state powers, and the answer to the objection was based upon general considerations and treated the "power to transmit or the transmission or receipt of property by death" as all standing on the same footing. 178 U.S. 57, 59. After the elaborate discussion that the subject received in that case we think it unnecessary to dwell upon matters that in principle were disposed of there. The same may be said of the argument that the tax is direct and therefore is void for want of apportionment. It is argued that when the tax is on the privilege of receiving, the tax is indirect because it may be avoided, whereas here the tax is inevitable and therefore direct. But that matter also is disposed of by Knowlton v. Moore, not by an attempt to make some scientific distinction, which would be at least difficult, but on an interpretation of language by its traditional use — on the practical and historical ground that this kind of tax always has been regarded as the antithesis of a direct tax; "has ever been treated as a duty or excise, because of the particular occasion which gives rise to its levy." 178 U.S. 81-83. Upon this point a page of history is worth a volume of logic.
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> The inequalities charged upon the statute, if there is an intestacy, are all inequalities in the amounts that beneficiaries might receive in case of estates of different values, of different proportions between real and personal estate, and of different numbers of recipients; or if there is a will affect legatees. As to the inequalities in case of a will they must be taken to be contemplated by the testator. He knows the law and the consequences of the disposition that he makes. As to intestate successors

the tax is not imposed upon them but precedes them and the fact that they may receive less or different sums because of the statute does not concern the United States. [256 U.S. at 348-349.]

The federal estate tax was again upheld, against a farrago of additional contentions, in Heitsch v. Kavanagh, 200 F.2d 178 (6th Cir. 1952), cert. denied, 345 U.S. 939. See generally Eisenstein, Estate Taxes and the Higher Learning of the Supreme Court, 3 Tax L. Rev. 395, 397-408 (1948).

NOTE

1. *Income tax basis of inherited property.* In the income tax part of this book, it was pointed out that the "basis" to the recipient of property acquired by bequest, inheritance, or devise is its fair market value at the time of the decedent's death (or on the optional valuation date, if that date is elected, infra page 1335). §1014(b)(1); supra p. 146. According to the income tax regulations, this means the value of the property "as appraised for the purpose of the Federal estate tax" if the estate is subject to estate tax. Regs. §1.1014-3(a). Although this valuation, under the cases, does not preclude the heir or legatee from proving a higher value, it will at least be entitled to a presumption of correctness. Plaut v. Munford, 188 F.2d 543 (2d Cir. 1951); Rev. Rul. 54-97, 1954-1 C.B. 113 (estate tax value may be rebutted by "clear and convincing evidence," unless taxpayer is estopped by his previous actions or statements); see also Ford v. United States, supra page 875, to the effect that the heir is not subject to the doctrine of recoupment on using the true value after a lower value was employed in computing the estate's tax liability.

Because of its presumptive weight, a high estate tax value for property of uncertain or disputed value may be advantageous to the heir or legatee; and his immediate or eventual income tax savings may exceed the resulting additional estate tax. Would the executor violate his fiduciary duty to the estate if he voluntarily placed a high value on such property or accepted without contest a high valuation asserted by the government? Would it be improper for the heir or legatee to reimburse other persons interested in the estate to the extent that the additional estate tax burden would fall on them? See Pascal's Estate v. Commissioner, ¶63,336 P-H Memo T.C., involving an option owned by the decedent to produce a musical play and motion picture based on Shaw's "Pygmalion," which was valued at zero in the estate tax return. The government asserted a deficiency based on a value of $200,000, whereupon the estate claimed a value of $1,140,000. The explanation of this curious reversal of roles is, presumably, that the success of "My Fair Lady" made a high basis for income tax purposes worth more than the added estate tax. The court upheld the value used by the government in asserting the deficiency.

Although §1015(d), enacted in 1958, permits the donee's basis for property received by gift to be adjusted in certain situations to reflect the gift tax paid on the transfer, no such adjustment to reflect the federal estate tax is authorized. See Levy's Estate v. Commissioner, 17 T.C. 728 (1951). If property received by gift is later included in the donor's gross estate for federal estate tax purposes (e.g., because the gift was a transfer in contemplation of death), however, the donee's basis for the property is no longer governed by §1015 (property received by gift) and becomes subject to §1014 (property acquired from a decedent). Although the estate tax value may be less than the donor's cost, it will frequently be higher, in which event the shift in basis will be advantageous to the donee. Moreover, since the burden of the estate tax will not necessarily fall on the donee (infra p. 1360), he may get an increased basis at the expense of the decedent's other heirs. How is the phrase "property . . . required to be included in determining the value of the decedent's gross estate," as used in §1014(b)(9), to be interpreted if there is a compromise at the administrative level under which half the value of a gift is included? Must property have been *actually* included to bring §1014(b)(9) into play, or does it embrace property that should have been, but was not, included? Chirelstein, Some Aspects of Basis and the Proposed Regulations, 35 Taxes 151 (1957).

The fact that appreciated property takes on a "stepped-up" basis at death is important

to the estate planner, and it may also have an effect upon the liquidity of investments, especially those held by older persons. (Depreciated property takes on a "stepped-down" basis on the owner's death, but this fact is counterbalanced to a degree by the owner's power to sell during his lifetime if the income tax deduction for the decline in value will be useful to him.)

As indicated supra pages 486-487, President Kennedy's 1963 Tax Message recommended that the transfer of certain capital assets by gift or at death be treated as a realization of the net appreciation in such assets, subject to a number of exceptions and limitations. The House Ways and Means Committee recommended against enactment of this proposal, and also rejected an alternative proposal for a carryover of the decedent's basis for assets transferred at death.

2. *Income in respect of a decedent: §691.* Section 691 sets out special rules for the income tax treatment of "income in respect of a decedent." This term is not defined in the statute and its full reach is still unknown, but an example is a claim for unpaid wages held by the estate of a decedent who did not take the claim into income when it arose because he was on the cash basis of reporting income. Under §691, the estate must report income if it collects the claim; if it distributes the claim to a legatee, however, the income will be reported by the legatee when he collects it. It is important to note that §691 creates an exception to the usual rules (a) that inherited property takes on a new basis equal to its value at the date of death, and (b) that property acquired by bequest, devise, or inheritance is not taxable as income to the recipient (supra p. 144). Items that constitute "income in respect of a decedent" do not take on a new basis, and must be reported as income if and when collected by the estate or heir.

Section 691's method of taxing the income to the estate or the heir, depending on who collects it, was adopted in 1942 to replace the prior requirement (in force from 1934 to 1942) that such items be included (even though still uncollected) in the final income tax return of the decedent. The 1934-1942 method was objectionable because it piled up in the final return many items that might be collected only gradually, especially since the Supreme Court construed the 1934 statute very broadly in Helvering v. Enright's Estate, 312 U.S. 636 (1941).

In addition to preserving the taxable status of "income in respect of a decedent," §691 provides a correlative deduction for the federal estate tax that was paid on the item by the decedent's estate. Thus, to continue with the example of the unpaid claim for wages, the estate or heir would have taxable income on collecting the debt from the employer, but would be allowed to deduct the estate tax attributable to its inclusion in the decedent's estate. For more on the complexities of §691, see Davison's Estate v. Commissioner, 292 F.2d 937 (Ct. Cl. 1961); United States v. Ellis, 264 F.2d 325 (2d Cir. 1959); Windhorst, Income in Respect of a Decedent, 37 Taxes 1082 (1959); Irell, Income in Respect of Decedents as Affected by the 1954 Internal Revenue Code, 1955 So. Calif. Tax Inst. 535 (1955); Shaw, Tax Problems When an Individual Dies with Unrealized Income, 1959 id. 721; A.B.A. Section of Taxation, 1960 Program 105-110 (recommending conversion of §691(c) deduction to credit).

3. *Foreign real estate.* Until 1962, §2031(a) and §2033 provided that real property situated outside the United States was not includible in the gross estate. In 1962, this exemption was eliminated in the case of persons dying on or after July 1, 1964; for persons dying after October 16, 1962, and before July 1, 1964, the exemption was preserved, but only as to real property acquired before February 1, 1962.

The pre-1962 blanket exemption was based in part on supposed international custom, and partly on a policy of accommodating United States citizens living abroad for business reasons. See S. Rept. No. 558, 73d Cong., 2d Sess., reprinted in 1939-1 C.B. (Part 2) 621; Laird v. United States, 115 F. Supp. 931 (D. Wis. 1953). Repeal of the exemption was based partly on a view that it had led to foreign investments in foreign real estate in countries with low, or no, death taxes primarily for tax advantage, and that the enactment in 1951 of a credit for foreign death taxes (infra p. 1330) protected United States taxpayers against double taxation in this area and hence lessened the need for the exemption. H.R. Rept. No. 1447, 87th Cong., 2d Sess., reprinted in 1962-3 C.B. 405, 487. See generally Wender, Federal Estate Tax Treatment of Real Property Situated Outside the United States, 19 Tax L. Rev. 91 (1963).

4. *Double taxation.* United States citizens and resident aliens are taxed by §2031(a) upon "all property . . . wherever situated," and hence are subject to double taxation if they own property within the jurisdiction of another country. The burden of double taxation is partially mitigated by treaties with a number of foreign countries under which the country of citizenship or domicile agrees to allow the decedent's estate a credit for foreign death taxes paid on property having its "situs" in the other contracting country. Situs is defined by the treaties; the treaty with the United Kingdom, for example, provides that tangible property has its situs in the country where it is physically located, corporate shares in the country of incorporation, insurance proceeds, bonds, and bank deposits in the country of the owner's domicile, judgment debts in the country of recordation, etc. See Gornick, The Canadian and British Death Tax Conventions, 50 W. Va. L.Q. 55 (1946); Rado, Estate Tax Convention Between Great Britain and the United States, 2 Tax L. Rev. 479 (1947); Sweeney, Nonresident Estate Taxes Under the United States and United Kingdom Convention, 25 Taxes 903 (1947). Would it be more desirable for each of the treaty countries to tax only its own domiciliaries? See Griswold, The Canadian Death Tax Convention, 23 id. 402 (1945).

Because treaties have not been negotiated with all foreign countries imposing death taxes on U.S. citizens and resident aliens, and because in some instances the treaties do not produce complete relief against double taxation, Congress enacted in 1951 a statutory credit for foreign death taxes. This provision, §2014, permits the estate to credit against its U.S. estate tax liability, as a kind of down payment, the death taxes paid to any foreign country "in respect of any property situated within such foreign country and included in the gross estate." The situs rules to be applied are those prescribed by §§2104-2105 for determining the situs of property owned by a nonresident alien in computing his gross estate. There are several limitations on the credit; the principal one is that if the United States taxes the property at a lower effective rate than the foreign country, only the lower amount can be credited.

Where §2014 overlaps a treaty, the larger credit may be taken. For a detailed examination of the effect of §2014 and the Canadian treaty on Canadian investments by U.S. citizens and resident aliens, see Molloy and Woodford, Estate Planning Techniques and the Ownership of Canadian Securities, 62 Yale L.J. 147 (1953). These authors conclude: "Three different sets of situs rules — those laid down in the Convention, those under the Code, and those applicable to [the provincial death taxes of] Ontario and Quebec — must be mastered and applied when making inter vivos investments and when drafting wills. . . . Proper will drafting techniques can save as much as 14.8 percent of the total combined death taxes otherwise payable on a net Federal estate of U.S. $500,000, 7.8 percent in the case of a U.S. $1,000,000 estate, and 11.08 percent in the case of a U.S. $2,000,000 estate, without the slightest alteration in the substantive dispositive provisions of such will." 62 Yale L.J. at 169-170.

5. *Nonresident aliens.* In the case of a nonresident alien, the estate tax is imposed on the transfer of only "that part of his gross estate (determined as provided in section 2031) which at the time of his death is situated in the United States." §2103. In Burnet v. Brooks, 288 U.S. 378 (1933), the statute was upheld as to, inter alia, bonds of foreign governments and corporations owned by a British subject resident in Cuba, the basis of jurisdiction being that the bonds were in the possession of the decedent's U.S. agents. See Regs. §20.2104-1(a)(3), providing that the "written evidence of intangible personal property which is treated as being the property itself" (e.g., a corporate bond) is part of the gross estate if physically situated here; other debts are part of the gross estate only if the debtor is located in the United States. Under §2104(a), enacted in 1954, however, shares of stock of foreign corporations are not included in the gross estate, regardless of where the certificates are located.

The scope of §2103 is qualified by §2105(a), exempting life insurance proceeds, and by §2105(b), exempting "moneys deposited with any person carrying on the banking business" if the decedent was not engaged in business here at the time of his death. See also §2106(c) (certain U.S. bonds). For the estate tax status of property that is located in the United States only temporarily, see Delaney v. Murchie, 177 F.2d 444 (1st Cir. 1949). See also §2105(c), exempting from tax works of art owned by a nonresident alien if loaned for exhibition to a nonprofit gallery or museum. This exemption originally

applied only to works exhibited at the National Gallery of Art in Washington, 64 Stat. 576, and was apparently intended to protect a collection of paintings lent to that gallery by an 81-year-old Armenian art collector. See Coughlan, Mystery Billionaire, Life, Nov. 27, 1950, p. 81.

The estate of a nonresident alien is entitled to an exemption of only $2000 and its deductions are subject to special limitations, as set out in §2106. The estate may, of course, be entitled in the country of domicile to a credit for the United States tax, under the treaties mentioned supra, or under other provisions of local law. See Wurzel, Nonresident Aliens and Federal Estate Tax: A Legislative Problem, 40 Colum. L. Rev. 52 (1940).

Transfers by nonresident aliens are also exempt from gift tax under certain conditions, but the exemptions are not identical with those granted by the estate tax law. See §§2501(a), 2511(a), and 2511(b).

See Schneider, Aliens and the United States Estate and Gift Taxes, 35 Taxes 281 (1957).

RHODES' ESTATE v. COMMISSIONER

41 B.T.A. 62 (1940)

[When the decedent, Mamie D. Rhodes, died on January 22, 1934, she owned 1000 shares of common stock of International Shoe Company, inherited by her from her husband on his death in 1924. The government asserted that another 4000 shares (also originally owned by her husband), which were registered in her name following her husband's death and pledged by her as collateral for a debt, should have been included in her gross estate under §2033. The administrators of her estate contended that these shares were properly excluded, on the ground that her interest in them was limited to a life estate and terminated on her death. Following her death, there were certain state court proceedings relating to these shares, which are described below.]

BLACK, Judge. . . .

What was the decedent's "interest" in the property [under §2033] the value of which the respondent has included in the decedent's gross estate? The respondent contends that the decedent was the sole owner of all the property which she attempted to dispose of in her will, including the shares of International Shoe Co. stock assigned to her by her children on or about July 30, 1925, and that the two decrees of the Circuit Court of St. Louis County, Missouri, referred to in our findings, are not binding upon the Board as requiring a holding contrary to the respondent's determination.

Petitioners contend that the determination of the decedent's "interest" in the property in question is purely one of the determination of property rights, and, as such, is controlled by the two decrees of the local circuit court.

We agree with the petitioners' contention. If the decedent owned only a life estate in the International Shoe Co. stock assigned to her in 1925 by her children, no part of the value of such property so assigned should be included in her gross estate, only her own share of the stock which she inherited from her husband's estate, which was one-fifth [i.e., 1000 shares], should be included. Article 11 of Regulations 70, 1929 ed. and Regulations 80, 1934 ed., and article 13 of Regulations 80, 1937 ed., all provide: "Nor shall anything be included [in the decedent's gross estate] on account of an interest or an estate limited for the life of the decedent." * The determination of whether the decedent owned only a life estate in the property assigned to her in 1925 by her children or whether she owned an absolute interest therein is clearly a determination of property rights, and, as such

* This provision has been dropped from the Regulations, but there is no reason to believe that this was intended to be a change of substance. — ED.

is controlled by local law. Poe v. Seaborn, 282 U.S. 101; Tyler v. United States, 281 U.S. 497; Freuler v. Helvering, 291 U.S. 35; Blair v. Commissioner, 300 U.S. 5; . . .

The Circuit Court for the County of St. Louis, State of Missouri, Division No. 2, after a full hearing in the matter, decreed on March 21, 1935, that the assignment executed by the children on July 30, 1925, "be and the same is hereby reformed as of the date of its execution to read" that the children "hereby jointly and severally grant, transfer and assign to our said mother, Mamie D. Rhodes, an estate, for her life only, in and to our joint and several interests in said estate of Taylor Rhodes, deceased. . . ." The assignment as reformed also provided that upon the death of Mamie D. Rhodes "that certain life estate which we hereby assign to her shall terminate and our said joint and several interests shall thereafter be held and owned by us as if this instrument had not been executed."

There is no evidence that this decree was obtained for the purpose of defeating any Federal estate tax; or that it was obtained by collusion. Such evidence as we do have points to the fact that it was a decree rendered after there was a hearing on the merits and was not a mere consent decree. The respondent has placed in evidence before us the testimony of Leona Kemp, who testified at the hearing before the local circuit court held on March 15, 1935. The substance of her testimony was that she was the secretary to W. E. Baird, the attorney who prepared the original assignment; that Baird had since died; that prior to the preparation of the assignment she remembered seeing "Mr. and Mrs. Paul Rhodes and Mr. Hugh Rhodes" at Baird's desk, which was adjacent to her own; that she "heard Mr. Paul Rhodes tell Mr. Baird he wanted to have him draw up a document whereby they could give their share of the estate to their mother for the time of her life, and Mr. Baird made a notation on his calendar pad"; that about four or five days later, Baird placed a paper written in longhand on her desk and asked her to copy it; and that the paper thus handed to her was the original assignment. All of the evidence before us, including recitals in the decree itself, indicates that the decree was rendered after a hearing on the merits and was in every respect regular. It was a decree adjudicating property rights. There is no evidence that it was ever modified or reversed, and, upon the authority of the above cited cases, it must be taken as establishing conclusively that the children assigned to their mother only a life estate in their interest in their father's estate.

Shortly after the reformation decree J. Jackson Rhodes and Hugh D. Rhodes, individually, and as executors and trustees under the will of Mamie D. Rhodes, deceased, filed a suit in the Circuit Court of the County of St. Louis, State of Missouri, May term, 1935, against Paul T. Rhodes, individually and as one of the trustees under the will of Mamie D. Rhodes, deceased, and Mary B. Rhodes, praying "for a decree of this court determining the ownership of all of the property held in the name of Mamie D. Rhodes at the time of her death on January 22, 1934, as between the estate of said Mamie D. Rhodes on the one hand and the plaintiffs and defendants herein on the other, and for such other and further orders and decrees as to the court may seem just and proper." The circumstances surrounding this suit are fully set out in our findings and need not be repeated here. Suffice it to say that on June 5, 1935, the court handed down its decree, in which it gave full faith and credit to the decree of the Circuit Court of the County of St. Louis, Division No. 2, heretofore mentioned and discussed.

It is our opinion that the two decrees in evidence before us establish conclusively that the decedent did not own outright any more than one-fifth of the 5,000 shares of common stock of the International Shoe Co. which the respondent has included in her gross estate and we have so found in our findings of fact. Her "interest" in the remaining four-fifths of the 5,000 shares was a life interest, which

ceased with her death, and under the above cited provisions of the respondent's regulations it was error for the respondent to include as a part of the decedent's gross estate the value of 4,000 shares, amounting to $194,000. . . . Even if it should be held that the second court decree rendered by Division No. 3, June 5, 1935, was a consent decree because it followed substantially the lines of a written agreement which had been previously entered into by the parties, nevertheless, the first court decree of Circuit Court No. 2, reforming the original instrument of transfer, was not a consent decree and settled the question as to ownership of the International Shoe Co. common stock and we are bound by it.

The respondent stresses the importance of the fact that the decedent, after the original assignment from her children in 1925, thereafter treated the property as her own. It is true that she so testified in the affidavit* referred to in our findings: that she actually sold 3,000 shares of the stock; that she pledged the remaining stock on loans; and that she attempted to dispose of all the stock in her will. As we look at this case, those were the facts for the local circuit court to consider in arriving at its decision in the matter. We may not assume that it did not do so. The decree having been rendered by a court of competent jurisdiction in a suit between adverse parties after a hearing upon the merits, we feel that we are bound by it. Whether the decree ever should have been rendered under the evidence is not a matter for us to decide. The question of property rights there decided is no longer an open question for the Board or the Federal Courts to consider. Freuler v. Helvering; Blair v. Commissioner; Sharp v. Commissioner, all supra.

The conclusion which we here reach is not contrary to our recent decision in Estate of Arthur D. Forst, 40 B.T.A. 876. In that case we held that a decree of the Orphans' Court of Mercer County, New Jersey, approving a certain claim against the estate was not binding upon the Board as to whether the claim was deductible under section 303 of the Revenue Act of 1926, in arriving at the net estate.† The question was altogether different from the one we have here to decide. Congress has established its own criterion as to what claims are deductible. Cf. Lyeth v. Hoey, 305 U.S. 188.

In view of our holding on the first issue, we need not decide the second issue.

Reviewed by the Board.

Decision will be entered for the petitioners.

STERNHAGEN, dissenting.

I do not think that this Board is universally bound by a decree of a state court without regard for the circumstances in which it is rendered. The record in this proceeding does not prove that there was a substantial controversy in which the mother or her estate was unsuccessful in establishing that when she died she owned the International shares and in which the children established against opposition that she had but a life estate. On the contrary it proves that the state court decree was the sanction of a mutually satisfactory agreement in which no one — the administrator ad litem, the creditors, the heirs and legatees, or anyone else — was adversely interested. Whether that was an arrangement deliberately aimed at the Federal Government's tax interest in the decedent's estate, it is not possible to say; but that still leaves it less than an adversary proceeding resulting in a judicial decree immune to Federal question. Generally I think my brother

* In connection with the settlement of her husband's estate tax liability, the decedent had filed an affidavit that her children had assigned to her their interests in his estate and that she was the sole person interested in her husband's estate. 41 B.T.A. at 62. — ED.

† The corresponding provision of the 1954 Code is §2053(a), allowing a deduction for such claims against the estate "as are allowable by the laws of the jurisdiction . . . under which the estate is being administered." — ED.

Opper* has correctly analyzed the state court proceedings and shown the fallacy of recognizing the decree as binding here.

NOTE

1. *Effect of local adjudications.* In affirming, the Court of Appeals for the Eighth Circuit (Helvering v. Estate of Rhodes, 117 F.2d 509, 510 (1941)) said:

> We are not unmindful of the argument for the Commissioner that instances may arise in which "the effect of accepting decrees of state courts as binding determinations of issues of fact presented in federal tax cases . . . would frequently be more undesirable" and that "the federal revenue could suffer considerably if the Commissioner were bound . . . in determining the taxability of the interests involved." But here an administrator ad litem was duly appointed and empowered to defend the estate of Mamie D. Rhodes, deceased, against an adversary suit. There is no evidence of any fraud or collusion or failure on the part of the administrator ad litem to perform his duty to defend the estate in good faith. Whether, if there had been such evidence, the Board of Tax Appeals could have disregarded the state court decree, it is not necessary to decide. The court had jurisdiction of the parties and the subject matter and the Board rightly held that the state court decrees were binding and determinative of the ownership of the property involved, and that ownership was not in Mamie D. Rhodes at the time of her death. See Blair v. Commissioner, 300 U.S. 5 (1937) and Sharp v. Commissioner, 303 U.S. 624 (1938), reversing per curiam 91 F.2d 802 (C.C.A. 3d 1937).

A established a testamentary trust, directing that the income be distributed "at such times and in such amounts as [the] trustee shall deem best" equally to B, C, and D. At B's death, the trustee held a substantial sum of accumulated, undistributed income. Thereafter, this sum was distributed by order of the probate court to C and D, who were the residuary beneficiaries of both A and B, as "the only persons interested in said [A's] estate." Does this order preclude an independent finding by the Tax Court that one third of the accumulated trust income was an asset of B's estate? Earle v. Commissioner, 157 F.2d 501 (6th Cir. 1946), cert. denied, 330 U.S. 882 (1947). See First-Mechanics National Bank v. Commissioner, 117 F.2d 127 (3d Cir. 1940); Commissioner v. Childs' Estate, 147 F.2d 368 (3d Cir. 1945); Krag v. Commissioner, 8 T.C. 1091 (1947). Does an appeal guarantee that a proceeding is adversary? Kelly's Trust v. Commissioner, 168 F.2d 198 (2d Cir. 1948).

Is there a difference in effect between a state court's findings of fact and its conclusions of law? Would it be feasible to permit or to require the United States to intervene in litigation that will affect the tax liability of the parties?

2. *Informal transfers during decedent's life.* If property (e.g., cash or securities) is found in the decedent's safe-deposit box with evidence that he intended to transfer it during his life to a donee, is it to be included in his estate under §2033 if the transfer was ineffective under local law (e.g., for want of delivery) but excluded otherwise, or is federal law controlling? See Richardson v. Commissioner, supra page 1011. If the transfer was effective under local law, should any significance be attached to the decedent's failure to file a federal gift tax return or to his practice of reporting the income from the property on his own federal income tax return? See Mortimer's Estate v. Commissioner, 17 T.C. 579 (1951); Sizer v. United States, 65 Ct. Cl. 450 (1928). If the subject of the alleged inter vivos gift was an interest in a family partnership, must it be included under §2033 if the transfer is ineffective for federal income tax purposes (supra p. 387)? See Aldrich v. Usry, 211 F. Supp. 330 (E.D. La. 1962); Kihchel v. United States, 105 F. Supp. 523 (W.D. Pa. 1952).

For an example of a successful claim that husband and wife were engaged in a business and professional partnership, although they had no formal agreement and kept no partnership accounts, with the result that only one half of the property held in the hus-

* The dissenting opinion of Judge Opper, in which Judges Hill and Disney joined, is omitted. — ED.

band's name or in joint bank accounts was included in his gross estate under §2033 on his death, see United States v. Neel, 235 F.2d 395 (10th Cir. 1956). The court reviewed the facts at length, and summarized as follows:

> Here, immediately after their marriage, [the decedent and his wife] pooled their cash and other property. Thereafter, each made substantial contributions of labor and services to their joint undertakings in farming, business, and the practice of law. On occasions they engaged in separate activities, but always the earnings from such separate activities were placed in their joint bank accounts. Each exercised authority, control, and management over the various business endeavois in which they jointly engaged. Each contributed substantial vital services in carrying on their joint undertakings. Moneys that came to each of them through inheritance were placed in the joint bank accounts. Each had authority and in fact did draw checks on their several bank accounts.
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> In Commissioner v. Culbertson [supra p. 388], the court laid down the following test: ". . . whether, considering all the facts — the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent — the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise. [337 U.S. at 742.]"
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> There was no express agreement with respect to the division of profits and losses, but the capital contribution of each was approximately equal, and the services rendered by each were approximately equal. Losses incurred in the operation of one of the hardware stores decreased the capital account, and, no doubt, the joint bank accounts. They made no distribution of profits to themselves individually, but continued to accumulate their joint and several earnings in joint bank accounts and other capital accounts.
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> We are of the opinion that it may be reasonably and fairly implied that [the decedent and his wife] agreed to contribute capital, to contribute substantial services, and to jointly manage and carry on as partners their several farming, business, and professional enterprises, and to share equally in the profits and losses realized as bona fide partners.
>
> Accordingly, we conclude that the findings of the trial court were not clearly erroneous and that the judgment should be and it is affirmed. [235 F.2d at 400-401.]

Is property includible if the decedent held title as trustee for the benefit of others? If he was the beneficial but not the record owner? Regs. §20.2033-1(a). What of property transferred to the decedent to hinder, delay, or cheat the transferor's creditors? Of property so transferred by the decedent? See McCann v. Commissioner, 87 F.2d 275 (6th Cir. 1937). An inter vivos transfer by the decedent may be vulnerable for various reasons (the transferor's minority, mental incapacity, and so on); conversely, the decedent may have received property in a tainted transaction. Should taxability turn on whether the transfer was "void" rather than "voidable"? On whether the transferor or only his creditors may recover the property? On whether an action for its recovery has or has not been brought by the decedent's executor (or by the transferor against the executor)? Safe Deposit & Trust Co. v. Tait, 54 F.2d 383 (D. Md. 1931), 70 F.2d 79 (4th Cir. 1934).

For gift tax problems in this area, see page 1011 supra.

3. *References.* Stephens and Freeland, The Role of Local Law and Local Adjudications in Federal Tax Controversies, 46 Minn. L. Rev. 223 (1961); Note, The Role of State Law in Federal Tax Determinations, 72 Harv. L. Rev. 1350 (1959); Cardozo (counsel for the government in *Rhodes' Estate,* supra), Federal Taxes and the Radiating Potencies of State Court Decisions, 51 Yale L.J. 783 (1942).

SECTION B. PROPERTY OWNED BY DECEDENT AT DEATH: §2033

BARR'S ESTATE v. COMMISSIONER
40 T.C. 164 (1963)

[The decedent's widow received a "wage dividend death benefit" of about $4500 from his employer, Eastman Kodak Company, under the following circumstances: The directors of Kodak were authorized by the shareholders to pay "wage dividends" in any year in which a dividend was paid on the common stock, if in the directors' opinion the corporation's cash position and earnings warranted such action, and wage dividends were paid in every year but one during the period 1912-1961. In November, 1957, 8 months after the decedent's death, the Kodak directors declared such a "wage dividend" for all employees on the payroll as of the end of 1957, based on the employee's wages for the 5 preceding years, to be paid in March, 1958. If an employee died after the end of 1957 but before the payment date in March, 1958, the "wage dividend" was paid to his estate as a matter of right. If he died before the end of 1957, his estate was not entitled to a wage dividend; but it was the company's practice to pay a "death benefit wage dividend" in such cases to the employee's spouse, children, or parents, and the company had regularly informed its employees that "the immediate survivors of Kodak people may expect" such a death benefit. In each such case, there was an investigation to determine whether "the circumstances of the deceased employee's family" justified payment; usually, but not always, a death benefit was paid equal in amount to the wage dividend that the employee would have received had he survived to the end of the year. From time to time, the company altered the eligibility rules for wage dividends; for example, in 1956 employees whose compensation exceeded $40,000 were made ineligible.

[The decedent's widow also received a "salary death benefit" of about $1750, under a company practice of paying an amount equal to the salary that would have been earned by a deceased employee during the balance of the pay period in which he died. The decedent was paid at 4-week intervals; he died at the end of the first week of his pay period and the payment was equal to 3 weeks' salary. The company's policy in paying "salary death benefits" was the same as its policy in paying "wage dividend death benefits," namely, payment was not guaranteed but depended on an exercise of judgment based on an investigation of the family's circumstances.]

PIERCE, Judge:

I. The first issue relates to the so-called "wage dividend" death benefit which Eastman Kodak Company paid to decedent's widow in March 1958 (approximately 1 year after decedent's death). And the question presented with respect to this, is whether the amount of such payment is includable in the gross estate of the decedent for Federal estate purposes, under either section 2033 or section 2039 of the 1954 Code. . . .

It will be observed that [§2033] relates only to *interests in property* which the decedent had at the time of his death. And, as the Supreme Court pointed out in the leading case of Knowlton v. Moore, 178 U.S. 41, the justification for the Government's power to subject such interests to the Federal estate tax rests on the principle that such interests *pass* from the decedent at death, and that the estate tax is an excise tax on the privilege of transmitting property at death to the

survivors of the decedent. To the same effect see New York Trust Co. v. Eisner, 256 U.S. 341.

It is our opinion that, in the present case, the decedent did not have at the time of his death any property interest, either in the "wage dividend" which Eastman's board of directors subsequently declared for the benefit of its living eligible employees (after it had declared a cash dividend for the benefit of its stockholders), or in the related death benefit which these directors then authorized to be paid to decedent's widow. Accordingly, there was no such interest which passed, or could have passed, from him to his widow; and hence no such interest upon which the excise tax on the privilege of transmitting property at death may be imposed under section 2033.

Both this Court and others have recognized that there is a distinction between *rights* of an employee to death benefits, and, on the other hand, mere *hopes* and expectancies on the part of an employee that death benefits may be paid. Thus, in the early case of Dimock v. Corwin, (D.C., E.D.N.Y.) 19 F. Supp. 56, affd. on other issues (C.A. 2) 99 F.2d 799, 306 U.S. 363, it was shown that the Standard Oil Company had adopted an annuity and insurance plan, subject to withdrawal or modification by Standard at its discretion, under which death benefits roughly equal to a year's salary of an employee might be paid to the widow of a deceased employee. The District Court concluded that the decedent had "only the right to render it possible for [his surviving spouse] to receive a grant from the Standard Oil Company, and that this did not constitute property of his" under the then applicable statute, section 302 of the Revenue Act of 1926, a statutory provision cognate to section 2033 of the 1954 Code.

In a more recent case decided by this Court, Estate of Albert L. Salt, 17 T.C. 92 (1951), the facts were closely similar to those of the instant case. There, the decedent was employed by Graybar Electric Company, which had a "Plan for Employees' Pension, Disability Benefits and Death Benefits," under section 7 of which it was provided that the company could, in the discretion of a committee appointed by the company to administer the plan, authorize death benefit payments to the wife, husband, or dependent relative of a deceased pensioner of the company. The company paid a death benefit to decedent's widow of $40,000. The company had paid similar death benefits in every case over a 15-year period, where there had been a qualified beneficiary of a deceased pensioner. We held that the respondent had erred in including said $40,000 in the decedent's gross estate; and we stated in part as follows:

> At the time of his death decedent had no vested interest in the $40,000 nor did his widow have an enforceable right to the $40,000. Whether she would receive it was entirely within the discretion of the committee administering the Plan. Since the decedent's "interest" in the $40,000 was a mere expectancy that his widow would receive the payment, it is not includible as a part of his gross estate under [§2033] of the Code. See Dimock v. Corwin, . . . [17 T.C. at p. 100].

Cases to the same effect are Estate of Emil A. Stake, 11 T.C. 817; Estate of William S. Miller, 14 T.C. 657; Estate of M. Hadden Howell, 15 T.C. 224.

Authorities reaching differing results on the basis of the decedents having *enforceable vested* rights to have their employers pay death benefits to survivors, are typified by Estate of Charles B. Wolf, 29 T.C. 441, 447, in which case we stated:

> At the date of decedent's death he had *enforceable vested* rights in the three trusts [one profit-sharing trust, and two pension trusts], procured by the rendition of services and by continuing in the employ of the respective corporations. He could be deprived of

those rights only by deliberately terminating his employment or being discharged for cause. He had unlimited power to designate or change beneficiaries, and payments to his named beneficiaries were obligatory. The rights thus created were valuable property rights, capable of valuation, and in fact valued by the parties. The decedent's death was the decisive event that resulted in the passage of those rights to the beneficiary. It seems clear to us that they are includible in his gross estate either under the sweeping provisions of [§2033] or under the more specific provisions of [§2041, dealing with powers of appointment]. Cf. Estate of William L. Nevin, 11 T.C. 59.

This case is to be sharply distinguished from cases such as Dimock v. Corwin, . . . where the employer retained the unfettered right to withdraw or modify the pension plan and where it was thought that the employee's interest could not rise above that of a mere expectancy. . . . [Citing the *Salt, Stake, Miller* and *Howell* cases, supra.] [Emphasis supplied.]

We are convinced that in the instant case, decedent had no more than a hope or expectancy that his surviving spouse might receive a wage dividend death benefit. There were so many events that had to occur before such hope could be realized that we find it impossible to conclude that, at the date of death, he had any property right which he could pass to her. Eastman had to realize earnings and profits for the year 1957; the directors, in the exercise of their discretion, had to declare a dividend to its stockholders; the directors, in further exercise of their discretion, had to declare a wage dividend payment to those employees who were alive and employed by the company on the last day of the Kodak year; and the directors, in the still further exercise of their discretion, had to approve a wage dividend death benefit to the widow of the instant decedent who had theretofore died. Moreover, the company, in its Rules of Eligibility and Participation and in the pamphlet distributed to its employees, made it clear that whether it might approve a wage dividend death benefit to the estate or beneficiary of a deceased employee was solely within its "option"; and that such situation would be distinguishable from that of an employee who had continued to live until after the close of the Kodak year for which the wage dividend was declared, and who thereby had acquired a "right" to the same.

We hold that section 2033 is not here applicable.

[Discussion of §2039 omitted; see page 1232 infra.]

II. The second issue is whether the salary death benefit which was paid to the decedent's widow is includable in the decedent's gross estate, under . . . §§2033 or 2039.

It is our opinion that what we have stated with respect to each of these sections in our consideration of the wage dividend death benefit is equally applicable to this salary death benefit. . . .

GOODMAN v. GRANGER

243 F.2d 264 (3d Cir. 1957), cert. denied, 355 U.S. 835

Before GOODRICH, KALODNER and STALEY, Circuit Judges.

KALODNER, Circuit Judge.

When does the federal estate tax attach?

More specifically stated, when does such tax attach to a decedent-employee's contractual right to annual deferred compensation payments from his employer, payable to his estate after his death?

That problem, of first impression, is presented by this appeal by the government from a judgment in favor of the taxpayer, Eleanor D. Goodman, administratrix of the estate of Jacques Blum, deceased, in a suit brought by her in the District Court for the Western District of Pennsylvania to recover estate taxes and interest alleged to have been erroneously assessed and collected.

The District Court, subscribing to the taxpayer's contention, concluded as a matter of law that the decedent's contractual right was to be ". . . valued during decedent's lifetime and *at the moment before death* . . ." and made the factual finding that at such moment the contractual right was "valueless," for reasons which will subsequently be discussed. In its opinion the District Court stated "It must be admitted that if the value in the contracts is to be fixed *the moment after death*, then the Government is correct in its contention in this case." (Emphasis supplied.)

The undisputed facts may be summarized as follows:

The decedent, Jacques Blum, for several years prior to his sudden death of a heart attack at the age of 52 on May 2, 1947, was executive vice-president of Gimbel Brothers, Inc. ("Gimbels") in charge of its Pittsburgh store.

On October 19, 1944, June 1, 1945 and May 26, 1946, decedent entered into identical contracts of employment with Gimbel Brothers covering the years ending January 31, 1945, January 31, 1946 and January 31, 1947, respectively. Each contract provided for a basic salary of $50,000 per year, and for additional "contingent benefits" of $2,000 per year for fifteen years "after the employee ceases to be employed by the employer" by reason of death or otherwise. The post-employment "contingent payments" were to be made only if the employee duly performed the services agreed upon and did not engage in a competing business within a specified period after termination of his employment; and they were to be reduced if his post-employment earnings from a non-competing business plus the contingent payments exceeded seventy-five percent of his yearly average compensation under the contracts. Any of the fifteen annual contingent payments which fell due after the employee's death were to be paid to his estate, or to a nominee designated in his will.

The third contract for the period of employment ending January 31, 1947 was, by its terms, renewed on a month-to-month basis and was in effect at the time of decedent's death. At the latter time there was every prospect that he would continue to advance in his highly successful career in retailing.[1]

After the decedent's death Gimbels paid the $6,000 annual installments provided by the three separate contracts ($2,000 each) to the taxpayer in her capacity as administratrix as they became due. She filed with the Collector a timely federal estate tax return and included the three contracts at a value of $15,000. Upon audit of the return the Internal Revenue Agent in Charge, Pittsburgh, increased the value of the three contracts from $15,000 to $66,710.34, the present worth of $90,000, payable in equal annual installments of $6,000 a year over a period of fifteen years. The increase in the value of the contracts resulted in a deficiency of $15,958.18, including interest, which was assessed against and paid by the taxpayer, and for the recovery of which she brought the suit here involved.

At the trial the taxpayer offered the testimony of three witnesses to the effect that the three contracts created no property right having any market value in the decedent while he lived.

The government offered the testimony of one witness who testified that the

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1 Each of the contracts provided for payment of amounts falling due after the employee's death, in the following language:

"6. Any of the fifteen (15) annual contingent payments which fall due after the death of the Employee shall be paid either (1) to such person as shall furnish evidence satisfactory to the Employer showing that under the last will and testament of the Employee or for other reason he is duly authorized in law to receive such payment, or (2) to such person as shall furnish the Employer with evidence of appointment as representative of the estate of the Employee. The receipt of any such person for such payments shall release the Employer of any further obligation in respect thereof. 'Person' as used in this Article 6 may include one or more individuals, trusts, firms or corporations."

deficiency assessment was based upon his conclusion that the contracts created in the decedent valuable vested interests, subject to being divested, and on that theory the contracts were considered by the government to have the marketable monetary value which it had determined and assessed.

The federal estate tax is imposed upon "the transfer" of a decedent's property, Internal Revenue Code [§2001], and the gross estate of the decedent is determined by including "the value at the time of his death of all property" to "the extent of the [decedent's] interest therein." [§2033.] Treasury Regulations [20.2031-1 (b)] provide that the measure of value for the purpose of determining the gross estate in federal estate taxation is the fair market value of the estate.

The sum of the taxpayer's position is (1) what is taxed is "the value" of the decedent's interest in his contract that "ceased by reason of death," not the value of what is received by the recipient (the administratrix); otherwise stated, "the value" of the decedent's interest in his contract was to be determined as "of the moment before death."

The government's position may be summarized as follows: (1) the estate tax is measured by the value of property transferred by death and here an absolute right to the fifteen deferred compensation payments passed by decedent's death to the taxpayer inasmuch as the possibility of forfeiture was extinguished by decedent's death; (2) the government properly valued the right to the deferred compensation payments in the same manner as an annuity for a term certain, *i.e.* at the commuted value in accordance with the applicable Treasury Regulations.

As earlier noted, the District Court agreed with the taxpayer's view. In doing so it stated:

> It seems clear under the authorities and the statute and the regulations that the value of the contract rights *is limited to the interest of the decedent during his lifetime.* That interest, under the testimony and by a fair preponderance of the evidence, is valueless. There was no fair market value on which to base a deficiency assessment. (Emphasis supplied.)

It may be noted parenthetically that the taxpayer's testimony as to lack of value, adverted to by the District Court, was premised on the circumstance that the employment contracts specified four contingencies which, if any of them had occurred, would have forfeited the decedent's right to the deferred compensation payments.

It is clear that the decedent's interest in the employment contracts was "property" includible in his gross estate under [§2033]. Determination of the time when that interest is to be valued is the crux of the dispute.

We have had the benefit of thorough discussions by both the government and the taxpayer of the nature of the federal estate tax. Both parties cited Knowlton v. Moore, 1900, 178 U.S. 41; Young Men's Christian Association of Columbus, Ohio v. Davis, 1924, 264 U.S. 47; and Edwards v. Slocum, 1924, 264 U.S. 61. The government cited them for the proposition that the subject of the tax is neither the property of the decedent, nor the property of the legatee, but rather the transfer of assets affected by death. The taxpayer emphasizes the language in these cases which supports the theory that what is taxed is the value of the interest that ceased by reason of death, not the value of what is received by the recipient. We are in accord with both of these general axioms which aid in clarifying the nature of the federal estate tax. However, the cases cited and the principles drawn therefrom are not decisive of the question posed by this case. While the nature of the tax has been discussed in numerous Supreme Court cases, the question of the proper time to determine the nature of a decedent's interest and the value thereof requires a more particularized analysis.

The taxpayer has ignored the very nature of the tax which it is urged is dispositive of this case. True, the tax reaches the "'. . . interest which ceased by reason of the death.'" Knowlton v. Moore, supra, at page 49, but the reference there was to the distinction between an estate tax and an inheritance tax. The inheritance tax is levied upon the individual shares of the decedent's estate after distribution to the legatees; the estate tax is imposed upon the total estate of the decedent which is transferred to the legatees. The estate tax has been characterized as "an excise imposed upon the transfer of or shifting in relationships to property at death." United States Trust Co. of New York v. Helvering, 1939, 307 U.S. 57, 60. The estate and inheritance taxes have the common element of being based upon the transmission of property from the dead to the living. New York Trust Co. v. Eisner, 1921, 256 U.S. 345. In Knowlton v. Moore, supra, the Supreme Court recognized this basic principle when it said at page 56:

> . . . tax laws of this nature in all countries rest in their essence upon the principle that death is the generating source from which the particular taxing power takes its being, and that it is the power to transmit, or the transmission from the dead to the living, on which such taxes are more immediately rested.

Since death is the propelling force for the imposition of the tax, it is death which determines the interests to be includible in the gross estate. Interests which terminate on or before death are not a proper subject of the tax. Assets may be acquired or disposed of before death, possibilities of the loss of an asset may become actualities or may disappear. Upon the same principle underlying the inclusion of interests in a decedent's gross estate, valuation of an interest is neither logically made nor feasibly administered until death has occurred. The taxpayer's theory of valuing property before death disregards the fact that generally the estate tax is neither concerned with changes in property interests nor values prior to death.[2] The tax is measured by the value of assets transferred by reason of death, the critical value being that which is determined as of the time of death.

As was so succinctly stated by Judge Hartshorne in Christiernin v. Manning, D.C.D.N.J. 1956, 138 F. Supp. 923, 925:

> There cannot be a decedent, till death has occurred. A decedent's estate is not transferred either by his will or by intestacy, till death has occurred. . . . And the decedent's interest in the property taxable is to be such interest "at the time of his death". . .

Here the employment contracts provided for additional "contingent" compensation of $6,000 per year for fifteen years to be paid to Blum or his estate after the termination of his employment by reason of death or otherwise. True, the right to these payments was forfeitable upon the occurrence of any of the specified contingencies. However, forfeiture as a result of the contingencies never occurred during Blum's lifetime, and any possibility of their occurrence was extinguished by his death. Gimbels has been making and the estate has been collecting the payments provided by the contracts. Valuation of the right to these payments must be determined as of the time of Blum's death when the limiting factor of the contingencies would no longer be considered. Death ripened the interest in the deferred payments into an absolute one, and death permitted the imposition of the tax measured by the value of that absolute interest in property.

In Mearkle's Estate v. Commissioner of Internal Revenue, 3 Cir., 1942, 129 F.2d

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[2] Cf. Newell v. Commissioner of Internal Revenue, 7 Cir., 1933, 66 F.2d 102, for the effect of the death of a key officer and shareholder in a corporation upon the valuation of stock in the corporation included in his gross estate. Also, in valuing a partnership interest of a decedent, goodwill attributable to the decedent's personal efforts is not valued due to the decedent's loss to the partnership. Estate of Gannon, 1954, 21 T.C. 1073; Estate of Maddock, 1951, 16 T.C. 324.

386, we considered the proper method of valuing an annuity upon the death of the decedent which by its terms was payable to the decedent during his life and to his wife for her life. The criterion adopted was the purchase price of an annuity contract upon the life of the wife measured by her life expectancy on the date of her husband's death. There is no reference in this test to the husband's life expectancy upon the date of his death or to the joint expectancies of the decedent and his wife. See Christiernin v. Manning, supra. The value of decedent's interest in the annuity up to the time of his death is not considered, and, as in the situation here involved, death cuts off prior limiting factors.[3]

For the reasons stated the judgment of the District Court will be reversed with directions to proceed in accordance with this opinion.

NOTE

1. *Employee death benefits.* In Dimock v. Corwin, cited in *Barr's Estate,* the plan was subject to modification by the company prior to the employee's death, but not retroactively, so that the company was obligated to pay a benefit in accordance with whatever schedule of payments was in effect when the employee died. The court held:

> The right to nominate or designate the person to receive the death benefit could not have been levied upon to satisfy a judgment against the decedent during his lifetime; had he become bankrupt, his trustee could not have realized anything thereon for creditors, nor could it have been sold or assigned by the decedent because it was merely a privilege extended to him by his employer, which was subject to withdrawal or modification at any time, under the quoted terms of the plan. [19 F. Supp. 56, 59 (E.D.N.Y. 1937).]

In G.C.M. 27,242, 1952-1 C.B. 160, the Internal Revenue Service ruled that the gross estate of an employee included, under §2033, a death benefit payable under a profit-sharing and retirement plan under the following circumstances:

> Under the provisions of the profit-sharing and retirement plan in the instant case, all contributions to the plan are made by the company. Each year the company transfers 15 percent of its net income to the trustee of the plan and the trustee allocates the contribution to the accounts of the eligible employees for that year on the basis of compensation and length of service of such employees. Income of the trust property and any amounts forfeited by employees by reason of discharge or termination of employment are also allocated on the same basis. Upon the death of a participating employee prior to retirement, the participating interest of such employee is paid to the beneficiary or beneficiaries designated by him or, in the event that no beneficiary was designated by the employee, to his executors or administrators. The company reserves the right to terminate or amend the plan. Upon termination, all contributions cease and the trustee is required to pay, as promptly as possible, over to the participating employees, or their beneficiaries, their participating interests. No amendment to the plan is effective (*a*) which attempts to divert the assets held by the trustee to purposes other than for the exclusive benefit of the participating employees and their beneficiaries, or (*b*) which, without his consent, affects the right of any employee whose participating interest has already become payable to him. The employer has a right to amend the plan to eliminate the provision for the payment of a death benefit to employees dying prior to the receipt of any benefits under

[3] In Estate of Harper, 1948, 11 T.C. 717, cited by taxpayer, there were included in decedent's gross estate notes of insolvent makers who by reason of the receipt of legacies under the decedent's will became solvent. The Commissioner valued the notes at face value. The Tax Court held to the contrary, subscribing to the view that the estate tax was "measured by the value of the interest transferred or which ceases at death," viz., the actual value of the then insolvent maker's assets. The result reached is consistent with our approach in the instant case, although the language used by the Tax Court was perhaps something less than fortunate.

the plan so long as the amendment does not destroy the right of an employee or his designee to receive a death benefit which had already become payable. . . .

. . . it is possible prior to the death of a participating employee for the employer to destroy the right of an employee's designee to receive the death benefit provided under the plan. However . . . this office is now of the opinion that the mere possibility that an employer may withdraw, prior to the death of an employee, the right of the employee's designee to receive a death benefit does not indicate an absence of a property interest of the decedent in the right to designate a beneficiary of the death benefit. . . .

Accordingly, it is the opinion of this office that where an employee has the right to designate the beneficiary of a death benefit under a profit-sharing and retirement plan, the employee, at the time of his death, is in possession of such rights as constitute property within the meaning of [§2033] of the Internal Revenue Code, provided that prior to the employee's death the employer has not withdrawn the right of the employee to designate a beneficiary, and has not eliminated all death benefits. [The ruling also states that the benefits are includible in the gross estate under §2037 (transfers taking effect at death), §2038 (revocable transfers), and §2042 (life insurance proceeds).]

G.C.M. 27,242 also announced that the Internal Revenue Service would no longer follow Dimock v. Corwin.

See also Garber's Estate v. Commissioner, 271 F.2d 97 (3d Cir. 1959); Wadewitz' Estate v. Commissioner, 39 T.C. 679 (1963); Charleston National Bank v. United States, 221 F. Supp. 271 (S.D.W. Va. 1963) (following Dimock v. Corwin); Worthen v. United States, 192 F. Supp. 727 (D. Mass. 1961) (year's salary paid to employee's widow, under contract executed during employee's lifetime, held not includible under §2033).

For the impact of §2039 on certain employee death benefits, see page 1232 infra.

2. *Social security benefits.* Social security benefits paid upon the death of an employee are not part of the gross estate, the Treasury has ruled, because:

. . . the decedent has no control over the designation of the beneficiaries or the amounts payable to them. The beneficiaries and the amounts payable to them are fixed by the provisions of the Social Security Act, as amended, and the payments are made directly to the beneficiaries. [E.T. 18, 1940-2 C.B. 285.]

Does this mean that if a minor dies before he is capable of making a will, his estate will not be subject to federal estate tax because he did not have an opportunity to choose his beneficiaries? If the power to designate a beneficiary is essential to estate tax liability for employee and social security death benefits, why is not that element supplied (even if the benefits are to be paid to persons selected by the employer or by Congress) by the decedent's decision to accept employment with a particular employer knowing that such benefits will be, or are likely to be, paid?

3. *Recovery for wrongful death.* In Rev. Rul. 54-19, 1954-1 C.B. 179, the Internal Revenue Service ruled that the estate of a decedent who died in an airplane crash did not include the executor's claim against the carrier for damages. The state wrongful death statute provided that the executor or administrator of the decedent could sue, but for the benefit of the decedent's intestate successors rather than for the benefit of his estate and legatees:

The decedent in his lifetime never had an interest in the right of action or in the proceeds. He did not create the right, it was created by statute and vested in the persons designated in the statute. Inasmuch as the decedent had no right of action or interest in the proceeds at the time of his death, nothing "passed" from the decedent to the beneficiaries. Accordingly, the amounts recovered by the beneficiaries would not be includible in the decedent's gross estate for Federal estate tax purposes.

What if the cause of action became part of the decedent's estate? What of a claim for pain and suffering during the decedent's last hours? Revenue Rul. 56-637, 1956-2 C.B.

600, applied the same principle to an award for death from occupational disease, paid under a workmen's compensation act, to the employee's dependents.

4. *Property of uncertain or disputed value.* Note that in Burnet v. Logan (supra p. 457), in which the court held that certain contract rights could not be realistically valued for income tax purposes, it implied that a lower standard is applicable — because it is now or never — in fixing an estate tax value. See Pascal's Estate v. Commissioner, ¶63,336 P-H Memo T.C. (option to produce a musical play based on Shaw's "Pygmalion," which resulted after the decedent's death in the production of "My Fair Lady"; held, option worth $200,000); Rev. Rul. 61-88, 1961-1 C.B. 417 (decedent's remainder interest in a trust, contingent on death of 44-year-old woman without issue, held includible at fair market value).

The Internal Revenue Service has ruled that the right of an attorney's estate to receive payment on a quantum meruit basis for legal services performed by the decedent under a contingent fee contract constitutes an interest in property within the meaning of §2033. (Under state law, in the event of the death of an attorney who was employed on a contingent fee basis, his estate is ordinarily entitled to recover the reasonable value of his services if the case is terminated successfully.) Rev. Rul. 55-123, 1955-1 C.B. 443. Since the right to collect on a quantum meruit basis arises only because of the attorney's death (and is contingent upon a successful termination of the litigation), does it come within the terms of §2033 ("property . . . to the extent of the interest therein of the decedent at the time of his death")? If it does, how can its value at the time of death be ascertained? See Duffield v. United States, 136 F. Supp. 944 (E.D. Pa. 1955); Estate of Nemerov v. Commissioner, ¶56,164 P-H Memo T.C.

See also Rodiek v. Commissioner, 33 B.T.A. 1020 (1936), excluding from the estate a claim against the United States for compensation for an erroneous seizure of property under the Trading with the Enemy Act; pursuant to a Senate resolution passed after the decedent's death, a proceeding was commenced in the Court of Claims, which was to report its findings to the Senate. The Tax Court said: "What that report may turn out to be, no one can now foretell, and even the most favorable recommendation which may be made by that court to the Senate will be of no force to establish an enforceable legal right. The Senate will then act upon its own judgment upon a broad standard of sovereign justice, and may uncontestably refute what the Court of Claims may recommend." 33 B.T.A. at 1045-1046. What if the Senate had acted favorably before the tax proceeding was commenced but after the decedent's death? What if the resolution had been passed *before* the decedent's death?

5. *References.* Tannenwald, Payments to Widows of Executives as an Element in Estate Planning, 18 N.Y.U. Inst. on Fed. Taxation 1131 (1960); Note, Estate Taxation of Contract Rights Subject to Conditions Precedent, 67 Yale L.J. 467 (1958); Comment, Estate Taxation of Employee Death Benefits, 66 id. 1217 (1957).

BULL v. UNITED STATES

295 U.S. 247 (1935)

MR. JUSTICE ROBERTS delivered the opinion of the Court.

Archibald H. Bull died February 13, 1920. He had been a member of a partnership engaged in the business of ship-brokers. The agreement of association provided that in the event a partner died the survivors should continue the business for one year subsequent to his death, and his estate should "receive the same interests, or participate in the losses to the same extent," as the deceased partner would, if living, "based on the usual method of ascertaining what the said profits or losses would be. . . . Or the estate of the deceased partner shall have the option of withdrawing his interest from the firm within thirty days after the probate of will . . . and all adjustments of profits or losses shall be made as of the date of such withdrawal." The estate's representative did not exercise the option to withdraw in thirty days, and the business was conducted until December 31, 1920, as contemplated by the agreement.

The enterprise required no capital and none was ever invested by the partners.

Bull's share of profits from January 1, 1920, to the date of his death, February 13, 1920, was $24,124.20; he had no other accumulated profits and no interest in any tangible property belonging to the firm. Profits accruing to the estate for the period from the decedent's death to the end of 1920 were $212,718.79, $200,117.-09 being paid during the year, and $12,601.70 during the first two months of 1921. . . .

1. We concur in the view of the Court of Claims that the amount received from the partnership as profits earned prior to Bull's death [$24,124.20] was income earned by him in his lifetime and taxable to him as such; and that it was also corpus of his estate and as such to be included in his gross estate for computation of estate tax. We also agree that the sums paid his estate as profits earned after his death [$212,718.79] were not corpus but income received by his executor, and to be reckoned in computing income tax for the years 1920 and 1921. Where the effect of the contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a sale, and payments made to the estate are for the account of the survivors. It results that the surviving partners are taxable upon firm profits and the estate is not. Here, however, the survivors have purchased nothing belonging to the decedent, who had made no investment in the business and owned no tangible property connected with it. The portion of the profits paid his estate was therefore income and not corpus; and this is so whether we consider the executor a member of the old firm for the remainder of the year, or hold that the estate became a partner in a new association formed upon the decedent's demise.

2. A serious and difficult issue is raised by the claim that the same receipt has been made the basis of both income and estate tax, although the item cannot in the circumstances be both income and corpus; and that the alternative prayer of the petition required the court to render a judgment which would redress the illegality and injustice resulting from the erroneous inclusion of the sum in the gross estate for estate tax. The respondent presents two arguments in opposition, one addressed to the merits and the other to the bar of the statute of limitations.

On the merits it is insisted that the government was entitled to both estate tax and income tax in virtue of the right conferred on the estate by the partnership agreement and the fruits of it. The position is that, as the contract gave Bull a valuable right which passed to his estate at his death, the Commissioner correctly included it for estate tax. And the propriety of treating the share of profits paid to the estate as income is said to be equally clear. The same sum of money in different aspects may be the basis of both forms of tax. An example is found in this estate. The decedent's share of profits accrued to the date of his death was $24,124.20. This was income to him in his lifetime and his executor was bound to return it as such. But the sum was paid to the executor by the surviving partners, and thus became an asset of the estate; accordingly, the petitioner returned that amount as part of the gross estate for computation of estate tax and the Commissioner properly treated it as such.

We are told that, since the right to profits is distinct from the profits actually collected, we cannot now say more than that perhaps the Commissioner put too high a value on the contract right when he valued it as equal to the amount of profits received — $212,718.99. . . .

While, as we have said, the same sum may in different aspects be used for the computation of both an income and an estate tax, this fact will not here serve to justify the Commissioner's rulings. They were inconsistent. The identical money — not a right to receive the amount, on the one hand, and actual receipt resulting from that right on the other — was the basis of two assessments. The

double taxation involved in this inconsistent treatment of that sum of money is made clear by the lower court's finding we have quoted.* The Commissioner assessed estate tax on the total obtained by adding $24,124.20, the decedent's share of profits earned prior to his death, and $212,718.79, the estate's share of profits earned thereafter. He treated the two items as of like quality, considered them both as capital or corpus; and viewed neither as the measure of value of a right passing from the decedent at death. No other conclusion may be drawn from the finding of the Court of Claims.

In the light of the facts it would not have been permissible to place a value of $212,718.99 or any other value on the mere right of continuance of the partnership relation inuring to Bull's estate. Had he lived, his share of profits would have been income. By the terms of the agreement his estate was to sustain precisely the same status quoad the firm as he had, in respect of profits and losses. Since the partners contributed no capital and owned no tangible property connected with the business, there is no justification for characterizing the right of a living partner to his share of earnings as part of his capital; and if the right was not capital to him, it could not be such to his estate. Let us suppose Bull had, while living, assigned his interest in the firm, with his partners' consent, to a third person for a valuable consideration, and in making return of income had valued or capitalized the right to profits which he had thus sold, had deducted such valuation from the consideration received, and returned the difference only as gain. We think the Commissioner would rightly have insisted that the entire amount received was income.

Since the firm was a personal service concern and no tangible property was involved in its transactions, if it had not been for the terms of the agreement, no accounting would have ever been made upon Bull's death for anything other than his share of profits accrued to the date of his death — $24,124.20 — and this would have been the only amount to be included in his estate in connection with his membership in the firm. As respects the status after death, the form of the stipulation is significant. The declaration is that the surviving partners "are to be at liberty" to continue the business for a year, in the same relation with the deceased partner's estate as if it were in fact the decedent himself still alive and a member of the firm. His personal representative is given a veto which will prevent the continuance of the firm's business. The purpose may well have been to protect the good will of the enterprise in the interest of the survivors and to afford them a reasonable time in which to arrange for their future activities. But no sale of the decedent's interest or share in the good will can be spelled out. Indeed the government strenuously asserted, in supporting the treatment of the payments to the estate as income, that the estate sold nothing to the surviving partners; and we agree. An analogous situation would be presented if Bull had not died, but the partnership had terminated by limitation on February 13, 1920, and the agreement had provided that, if Bull's partners so desired, the relation should continue for another year. It could not successfully be contended that, in such case, Bull's share of profit for the additional year was capital.

We think there was no estate tax due in respect of the $212,718.79 paid to the executor as profits for the period subsequent to the decedent's death.

[The Court's discussion of a second issue, application of the doctrine of recoupment (supra p. 872), is omitted.]

* In a previous proceeding, the Board of Tax Appeals had held that the sum of $200,117.09 received by the estate in 1920 was taxable as income for that year. 295 U.S. at 252-253. — Ed.

McCLENNEN v. COMMISSIONER

131 F.2d 165 (1st Cir. 1942)

Before MAGRUDER, MAHONEY and WOODBURY, Circuit Judges.

MAGRUDER, Circuit Judge.

Placing their chief reliance upon Bull v. United States, 1935, 295 U.S. 247, the petitioners, as executors under the will of George R. Nutter, deceased, seek a review by us of a decision by the Board of Tax Appeals sustaining in part the Commissioner's determination of a deficiency in the estate tax of Mr. Nutter. The Commissioner conceded error as to one item, in respect to which the Board made appropriate adjustment in redetermining the deficiency.

George R. Nutter had been a partner in the firm of Nutter, McClennen & Fish, practising law in Boston, Massachusetts. The firm kept its accounts on the cash receipts and disbursements basis. Its receipts were derived solely from personal services. Under the partnership agreement Mr. Nutter's share of the firm's net profits was 8 per cent. The agreement also contained the following provisions:

> On the retirement of a partner or on his death — the others continuing the business — the retiring partner or his estate in the case of his death shall, in addition to his percentage of net profits of the Firm received by it in cash up to the date of such death or retirement, also receive the same percentage of net profits of the Firm received by it in cash until the expiration of the eighteen (18) calendar months next after such retirement, or death, and this shall be in full of the retiring or deceasing member's interest in the capital, the assets, the receivables, the possibilities and the good will of the Firm. The continuing members shall have the right to the good will and the use of the Firm name except the deceasing or retiring member's name shall not be used without his written consent or that of his estate.
>
> The present book value of the Plant, Books, etc., and the Cash Capital of the Firm used to carry uncollected disbursements, etc., shall be furnished in accordance with the proportions of the partners' profit sharings for 1936. This will be accomplished by appropriate debits and credits on the books. These capital items are to be readjusted from time to time as profit sharing percentages change.

Mr. Nutter died on February 21, 1937. The balance sheet of the partnership, as of the date of Mr. Nutter's death, indicates the interests of the partners in the firm assets by reference to accounts described as follows: "Capital Account," $12,375, "Plant Account," $8,932.44, and "Undistributed Profits," $73,634.50. The share of the deceased in these three accounts was, respectively, $1,031.25,[1] $744.37,[1] and $6,136.21. The capital account represents the interest of the partners in a working cash balance, and the plant account represents the interest of the partners in such items as books, furniture, and other fixtures in the law office. The firm owned a lease upon its offices, ending February 28, 1939. It was found by the Board that the firm enjoyed good will, in which the decedent had an interest and to which he contributed.

At the date of Mr. Nutter's death the firm and the members thereof had rendered legal and related services for which payment had not been received. Some of such work had been completed and some had not been completed on February 21, 1937. No consideration was given to such completed and partially completed services, which had not been paid for, in computing Mr. Nutter's share, amounting to $6,136.21, of the undistributed profits of the firm at the date of death.

[1] These two amounts are slightly more than 8 per cent of the total capital account, and plant account, respectively. This is because under the partnership agreement E. Louise Malloch, an employee and not a partner of the firm, is entitled to receive a share in the total earnings of the firm but has no share in its "capital" or "plant" account.

After the death of George R. Nutter the other partners continued the business. Eight per cent of the net profits of the firm for the 18 calendar months next after the death, computed on the basis of cash receipts and disbursements, amounted to $34,069.99, which amount was paid over to the petitioners as executors. Of this amount $28,069.46 represented 8 per cent of the net profits for the period of the year next after the death, and the remainder represented 8 per cent of the net profits for the last six months of the agreed 18 months' period.

Petitioners filed an estate tax return with the Collector of Internal Revenue at Boston, and paid the tax thereon shown to be due. On the said return they duly elected to have the property includible in the gross estate valued as of one year after decedent's death, in accordance with the method authorized by [§2032, infra p. 1335]. The sum of $6,136.21, which had been received by the executors as representing the decedent's share of the undistributed profits as of the date of the death, was included in the estate tax return as part of the decedent's gross estate. But beyond this nothing was included on account of the value of the decedent's interest in the partnership.

In his notice of deficiency the Commissioner determined that $34,069.99 should have been included in the gross estate as the value of decedent's "interest in partnership Nutter, McClennen & Fish." The Board has upheld the Commissioner in this determination. We think the Board was right.

In the absence of a controlling agreement in the partnership articles the death of a partner dissolves the partnership. The survivors have the right and duty, with reasonable dispatch, to wind up the partnership affairs, to complete transactions begun but not then finished, to collect the accounts receivable, to pay the firm debts, to convert the remaining firm assets into cash, and to pay in cash to the partners and the legal representative of the deceased partner the net amounts shown by the accounts to be owing to each of them in respect of capital contributions and in respect of their shares of profits and surplus. The representative of a deceased partner does not succeed to any right to specific partnership property. In substance the deceased partner's interest, to which his representative succeeds, is a chose in action, a right to receive in cash the sum of money shown to be due him upon a liquidation and accounting. . . .

This chose in action to which the representative of the deceased partner succeeds, the right to receive payment of a sum of money shown to be due upon a liquidation and accounting, is of course a part of the deceased partner's wealth, and includible in the decedent's gross estate for purposes of computing the estate tax by virtue of the comprehensive definition in [§2033]. This is none the less true even though the net amount thus shown to be due to the estate is derived in whole or in part from past earnings or profits of the partnership resulting from personal services — profits which the decedent, if he had lived, would have had to report as income. The valuation of this chose in action might be a matter of difficulty, especially in the case of a partnership which cannot be speedily liquidated and whose accounts are complicated. Nevertheless, for estate tax purposes, the valuation must be made by the legal representatives of the deceased partner, on the basis of the best evidence available at the applicable valuation date.

In the case at bar, if there had not been the controlling provision in the partnership articles, above quoted, or if the survivors had not come to some agreement otherwise with the executors of Mr. Nutter, the survivors would have had to proceed to wind up the affairs of the partnership, to conclude all unfinished legal business on hand at the date of the death, to realize upon all of the assets of the firm, tangible or intangible, to pay the debts, to return to Mr. Nutter's estate his contribution of capital, if any, and to pay to his estate in cash the

amount shown to be due in respect of his "interest in the partnership," that is, his "share of the profits and surplus," as determined upon an accounting. Among other things to be taken into account, "the earned proportion of the unfinished business" would have had "to be valued to determine the decedent's interest in the partnership assets." Helvering v. Enright's Estate, 1941, 312 U.S. 636, 641; United States v. Carter, 5th Cir., 1927, 19 F.2d 121.

To obviate the necessity of a liquidation, or to eliminate accounting difficulties in determining the value of the deceased partner's interest, partners often make specific provision in the partnership articles.

Sometimes the partnership agreement merely provides for the postponement of liquidation, say, to the end of the term for which the partnership was created. Thus, a partnership agreement between A, B and C might provide that "should any partner die during the term of said co-partnership the firm shall not be dissolved thereupon, but the business shall be continued by the survivors until the expiration of said partnership term, the estate of the deceased partner to bear the same share in profits and losses as would have been received and borne by the deceased partner had he lived." Under such an agreement, if A dies, B and C do not buy out A's interest in the partnership. Unless more appears, A's executor does not become personally liable as a general partner, Butcher v. Hepworth, 1889, 115 N.Y. 328, 329. Nor is A's general estate in the executor's hands liable as a partner for new debts created by B and C in continuing the business. Stewart v. Robinson, 1889, 115 N.Y. 328. For the remainder of the term, A's share already embarked in the business remains in, subject to the risks of the business. It would seem not improper to describe the continuing business as now being owned by B and C as general partners, with A's estate (or A's executor as trustee under the will of A) as a limited partner therein, sharing in the profits, but not liable beyond the amount of interest already embarked in the business.

In the case just supposed, the chose in action, the right to which A's executor succeeds, would have to be included as part of the gross estate for estate tax purposes. It is a right to a fixed share of the profits of the business during the continuance of the term, plus a right to receive in cash the amount due to A's estate upon a final liquidation and accounting after the expiration of the term. This right in its entirety is an asset of A at the date of his death; and the value of this right as of the date of the death or the optional date one year later, with due discount for postponement of payment and other contingencies, would be included in computing the value of the gross estate. Bull v. United States, 1935, 295 U.S. 247, was a peculiar case on its facts and in the way the case came up; but we do not understand this case to hold that a right to receive future income payments is not "property" includible in the gross estate. A similar instance is the case of a decedent who dies possessed of a bond for $1,000 payable in ten years bearing interest at 6 per cent. The bond in its entirety may be valued at par at the date of the death, and this amount will be included in the gross estate. But this valuation embraces two elements, (1) the present value of the bondholder's right to receive a principal payment of $1,000 ten years hence, and (2) the present value of the bondholder's right to receive periodic interest payments until the bond is due. If the bondholder had lived he would have had to report the interest payments as income; nevertheless, upon his death his right to receive such future income payments would be in effect included in his gross estate. So if a creditor lends a sum of money to a partnership under a contract whereby the principal sum is to be repaid at the end of ten years, and meanwhile, in lieu of a fixed rate of interest, the creditor is to receive a share of the profits, the periodic receipt of such profits would be income to the creditor; but if the creditor should die there would have to be included in his gross estate not only the right

to receive future repayment of the principal but also the right to receive a share of the profits for the balance of the term of the loan. Likewise if a life insurance agent, after the termination of his agency, has a contract right to renewal commissions payable to him for services which had previously been rendered in writing policies of insurance, the subsequent receipt by him during his lifetime of such commissions would no doubt be income to him, see Helvering v. Eubank, 1940, 311 U.S. 122, but it can hardly be doubted that upon his death his right to receive such future income payments would have to be included as part of his gross estate.

We have spoken of a common type of arrangement whereby liquidation of the partnership is merely postponed, the deceased partner's estate sharing in the profits meanwhile. The payment to the estate of a share of the intervening profits could in no sense be described as the purchase price for the deceased partner's interest, for the value of that interest is ultimately to be paid over to the legal representative upon a final liquidation and accounting at the end of the partnership term.

In the case at bar the partnership agreement contains another familiar arrangement, whereby no liquidation and final accounting will ever be necessary in order to satisfy the claim of the deceased partner. In place of the chose in action to which Mr. Nutter's executor would have succeeded in the absence of specific provision in the partnership articles, that is, a right to receive payment in cash of the amount shown to be due the deceased partner upon a complete liquidation and accounting, a different right is substituted, a right of the estate to receive a share of the net profits of the firm for 18 calendar months after the partner's death.

The language of the partnership agreement in the present case is couched in terms of a purchase of the deceased partner's interest. What the estate is to receive "shall be in full of the retiring or deceasing member's interest in the capital, the assets, the receivables, the possibilities and the good will of the Firm." There is to be an extinguishment of the decedent's interest in the totality of the firm assets, tangible and intangible, as they stood at the moment of death, and the interests therein of the surviving partners are to be correspondingly augmented. Decision in the estate tax case now before us does not turn on the question whether the effect of the partnership agreement may be characterized with entire accuracy as a "purchase" and "sale" of the deceased partner's interest in the partnership.

If the agreement had provided that at the expiration of 18 months after the death the deceased partner's estate shall receive $30,000 "in full of the deceased member's interest" no one could doubt that the commuted value of the right to receive this future payment of $30,000 would have to be included in valuing the decedent's gross estate. The nature of the transaction is not essentially changed if the sum to be paid is expressed in terms of a variable amount calculated by reference to a percentage of the net profits of the continuing business for a stated period. See our decisions in Hill v. Commissioner, 1 Cir., 1930, 38 F.2d 165, and in Pope v. Commissioner, 1 Cir., 1930, 39 F.2d 420, which cases were cited with approval in Bull v. United States, 1935, 295 U.S. 247, 254. Whether the payment to the estate is expressed in terms of a percentage of the net profits of the continuing business as in Pope v. Commissioner, supra, or in terms of an amount equal to a percentage of the net profits for the stipulated period, as in Hill v. Commissioner, supra, is a matter of form, not of substance. In either case the purpose of the agreement is to enable the survivors to satisfy the claim of the deceased partner and to continue the business without liquidation. Under this type of arrangement there is a clear implication in Bull v. United States, 1935,

295 U.S. 247, at page 254, that the substituted right to which the executor of the deceased partner succeeds must be included as a part of his gross estate.

In the present case the Commissioner valued Mr. Nutter's interest in the partnership at the sum of $34,069.99, which happened to be the exact amount received by the executors from the survivors as representing 8 per cent of the net profits of the partnership for the 18 calendar months after the death. There is no contention that this was an overvaluation. As bearing on the value of the right to receive 8 per cent of the net profits for such period, the Commissioner put in evidence past partnership earnings as follows:

1930	$311,215.09	1933	$343,810.80
1931	345,549.12	1934	366,881.59
1932	235,016.21	1935	405,492.26

The Board pointed out that at the optional valuation date, one year after death, the 8 per cent amounted to $28,069.46 and the contract still had six months to run. The Board said: "Certainly at the end of one year the contract was worth, at least, the amount it had already produced." Judging from this, and from the past history of the partnership's earnings, the indication then was that the contract right was worth considerably more than $34,069.99. The Board therefore concluded that the Commissioner "did not err in adding to gross estate $34,069.99." We agree.

In this case we do not have to consider any questions involving the income taxes payable by Mr. Nutter's estate or by his residuary legatee or by the surviving partners in respect of the profits made by the firm during the 18 months' period after Mr. Nutter's death. We intimate no opinion as to the many perplexing income tax problems lurking in the background. . . .

The decision of the Board of Tax Appeals is affirmed.

NOTE

1. *Relation to §691.* Section 691 (supra p. 1075) was enacted to deal with what Judge Magruder describes as "the many perplexing income tax problems lurking in the background." The predecessor of §691 (§126 of the 1939 Code) was enacted in 1942, after the taxable years involved in the *Bull* and *McClennen* cases. Would *Bull* have been decided as it was if the statute had then provided, as §691(c) now does, that the estate or legatee might deduct, on the income tax return, an appropriate portion of the estate tax when reporting "income in respect of a decedent"? Can the *Bull* case be reconciled with the *McClennen* case?

See Riegelman's Estate v. Commissioner, 253 F.2d 315 (2d Cir. 1958), which reviews this area and expresses the opinion that the *Bull* case "no longer states the applicable law."

2. *Income tax treatment of partnership liquidation.* The income tax treatment of partnership arrangements like that involved in the *McClennen* case was revised in 1954. As seen supra page 770, payments made in liquidation of the interest of a deceased partner are taxed as income to the estate or other successor, except to the extent that they are "made in exchange for the interest of such partner in partnership property." (The latter phrase may not include amounts paid for goodwill, unless provided for by the partnership agreement, or amounts paid for "unrealized receivables.") How would these rules be applied to the *McClennen* agreement? The value of the right to be paid for the decedent's interest in "partnership property" is clearly part of the estate under §2033. The rest of what the estate gets from the partnership seems, by reason of §753, to be "income in respect of a decedent." The Senate Report says (pp. 405-406) of §753:

> The House provision has been amended to make clear that all payments to the successor of a deceased partner coming within the provisions of section 736(a) are to be considered "income in respect of a decedent." Section 753 thus covers pay-

ments in the nature of mutual insurance as well as payments attributable to the decedent's interest in the unrealized receivables of the partnership. Thus, while a successor in interest of a decedent partner will be required to include in gross income amounts received from the partnership which are attributable to the value of the decedent's interest in unrealized fees or mutual insurance, the recipient will at the same time receive a deduction for the estate tax paid with respect to the inclusion of such rights to income in the decedent's estate.

Does this mean that the *Bull* case has been laid to rest by the 1954 Code?

3. *Estate as continuing partner.* Suppose the partnership agreement provides that the estate may continue *as a partner* for a period of time after death, receiving a share of the profits but also sharing in losses to the extent of the capital invested in the firm. Would the right to share in profits be included in the gross estate under §2033? Or is this simply a case of post-death earnings of the estate, to be treated like any other yield arising from a favorable investment of the estate's assets by the executor? Is this what occurred in the *Bull* case?

4. *Time for valuing interest.* The estate tax return is due 15 months after death. §6075(a). How can the value of the partnership interest be ascertained by then if the estate is entitled to share in the profits of a partnership for a number of years thereafter?

5. *Effect of restrictive agreements.* The courts in both *Bull* and *McClennen* accepted the arrangement for paying off the estate of the deceased partner as a bona fide business agreement. What if a partnership consists of a father and his two sons, and they agree that on the death of any one of them, his estate will receive $1 — or some other amount bearing no relationship to fair market value — for his partnership interest? For some of the problems that arise when courts probe beneath the surface of an agreement for buying out the interest of a deceased partner or shareholder, see page 1349 infra.

6. *References.* Friedman, Estate and Income Tax Aspects of Fees Due at Death, 18 N.Y.U. Inst. on Fed. Taxation; Bauman, Income in Respect of a Deceased Partner, 1963 So. Calif. Tax Inst. 383.

HELVERING v. SAFE DEPOSIT & TRUST CO.
316 U.S. 56 (1942)

MR. JUSTICE BLACK delivered the opinion of the Court.

Because of the importance in the administration of the Federal Estate Tax of the questions involved, we granted certiorari to review the judgment of the Circuit Court of Appeals, 121 F.2d 307, affirming a decision of the Board of Tax Appeals, 42 B.T.A. 145.

Zachary Smith Reynolds, age 20, died on July 6, 1932. At the time, he was beneficiary of three trusts: one created by his father's will in 1918, one by deed executed by his mother in 1923, and one created by his mother's will in 1924. From his father's trust, the decedent was to receive only a portion of the income prior to his twenty-eighth birthday, at which time, if living, he was to become the outright owner of the trust property and all accumulated income. His mother's trust directed that he enjoy the income for life, subject to certain restrictions before he reached the age of 28. Each of the trusts gave the decedent a general testamentary power of appointment over the trust property; in default of exercise of the power the properties were to go to his descendants, or if he had none, to his brother and sisters and their issue per stirpes.

The Commissioner included all the trust property within the decedent's gross estate for the purpose of computing the Federal Estate Tax. The Board of Tax Appeals and the Circuit Court of Appeals, however, held that no part of the trust property should have been included.

I

The case presents two questions, the first of which is whether the decedent at the time of his death had by virtue of his general powers of appointment, even if never exercised, such an interest in the trust property as to require its inclusion in his gross estate under [§2033].

The Government argues that at the time of his death the decedent had an "interest" in the trust properties that should have been included in his gross estate [under §2033], because he, to the exclusion of all other persons, could enjoy the income from them; would have received the corpus of one trust upon reaching the age of 28; and could alone decide to whom the benefits of all the trusts would pass at his death. These rights, it is said, were attributes of ownership substantially equivalent to a fee simple title, subject only to specified restrictions on alienation and the use of income. The respondents deny that the rights of the decedent with respect to any of the three trusts were substantially equivalent to ownership in fee, emphasizing the practical importance of the restrictions on alienation and the use of income, and arguing further that the decedent never actually had the capacity to make an effective testamentary disposition of the property because he died before reaching his majority.

We find it unnecessary to decide between these conflicting contentions on the economic equivalence of the decedent's rights and complete ownership.[1] For even if we assume with the Government that the restrictions upon the decedent's use and enjoyment of the trust properties may be dismissed as negligible and that he had the capacity to exercise a testamentary power of appointment, the question still remains: Did the decedent have "at the time of his death" such an "interest" as Congress intended to be included in a decedent's gross estate under [§2033]? It is not contended that the benefits during life which the trusts provided for the decedent, terminating as they did at his death, made the trust properties part of his gross estate under the statute. And viewing [§2033] in its background of legislative, judicial, and administrative history, we cannot reach the conclusion that the words "interest . . . of the decedent at the time of his death" were intended by Congress to include property subject to a general testamentary power of appointment unexercised by the decedent.

The forerunner of [§2033] was §202(a) of the Revenue Act of 1916, 39 Stat. 777. In United States v. Field, 255 U.S. 257, this Court held that property passing under a general power of appointment *exercised* by a decedent was not such an "interest" of the decedent as the 1916 Act brought within the decedent's gross estate. While the holding was limited to *exercised* powers of appointment, the approach of the Court, the authorities cited, and certain explicit statements in the opinion left little doubt that the Court regarded property subject to *unexercised* general powers of appointment as similarly beyond the scope of the statutory phrase "interest of the decedent."

After the *Field* case, the provision it passed upon was reenacted without change in the Revenue Act of 1921 and in the Revenue Act of 1924. If the implications of the *Field* opinion with respect to unexercised powers had been considered contrary to the intendment of the words "interest of the decedent," it is reason-

[1] In declining to pass upon this issue, we do not reject the principle we have often recognized that the realities of the taxpayer's economic interest, rather than the niceties of the conveyancer's art, should determine the power to tax. See Curry v. McCanless, 307 U.S. 357, 371, and cases there cited. Nor do we deny the relevance of this principle as a guide to statutory interpretation where, unlike here, the language of a statute and its statutory history do not afford more specific indications of legislative intent. Helvering v. Clifford, 309 U.S. 331.

able to suppose that Congress would have added some clarifying amendment. . . .

When it was held in the *Field* case that property subject to an *exercised* general testamentary power of appointment was not to be included in the decedent's gross estate under the Revenue Act of 1916, this Court referred to an amendment passed in 1919 which specifically declared property passing under an exercised general testamentary power to be part of the decedent's gross estate. The passage of this amendment, said the Court, "indicates that Congress at least was doubtful whether the previous act included property passing by appointment." 225 U.S. at 265. In the face of such doubts, which cannot reasonably be supposed to have been less than doubts with respect to *unexercised* powers, Congress nevertheless specified only that property subject to exercised powers should be included. From this deliberate singling out of *exercised* powers alone, without the corroboration of the other matters we have discussed, a Congressional intent to treat *unexercised* powers otherwise can be deduced. At the least, §302(f) of the 1926 Act,[2] the counterpart of the 1919 amendment referred to in the *Field* case, represents a course of action followed by Congress, since 1919, entirely consistent with a purpose to exclude from decedents' gross estates property subject to unexercised general testamentary powers of appointment.

In no judicial opinion brought to our attention has it been held that the gross estate of a decedent includes, for purposes of the Federal Estate Tax, property subject to an unexercised general power. On the contrary, as the court below points out, "the courts have been at pains to consider whether property passed under a general power or not so as to be taxable under Section 302(f), a consideration which would have been absolutely unnecessary if the estate were taxable under [§2033] because of the mere existence of a general power whether exercised or not." 121 F.2d 307, 312. In addition, the uniform administrative practice until this case arose appears to have placed an interpretation upon the Federal Estate Tax contrary to that the Government now urges. No regulations issued under the several revenue acts, including those in effect at the time this suit was initiated, prescribe that property subject to an unexercised general testamentary power of appointment should be included in a decedent's gross estate. Because of the combined effect of all of these circumstances, we believe that a departure from the long-standing, generally accepted[3] construction of [§2033], now contested for the first time by the Government, would override the best indications we have of Congressional intent.

II

[Omitted.]
Reversed.

NOTE

1. *Substantial ownership and §2033.* The powers of appointment provision, which is now §2041, was thoroughly revised in 1942 and again in 1951. The changes are examined in some detail infra page 1261, but it is worth noting here that if the decedent at the time

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2 "The value of the gross estate of the decedent shall be determined by including the value at the time of his death of all property, real or personal, tangible or intangible, wherever situated —

"(f) To the extent of any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death, except in case of a bona fide sale for an adequate and full consideration in money or money's worth, — " 44 Stat. 9, 70-71.

3 See 1 Paul, Federal Estate and Gift Taxation, p. 425: "As long as there is no actual or constructive exercise of the power, there can be no tax under the present statute."

of his death possesses a general power of appointment created after 1942, the property subject to the power is now includible in his estate even if he does not exercise it.

The great significance of the *Safe Deposit & Trust Co.* case is that the Court refused to read what is now §2033 in the expansive way it came to read §22(a) of the 1939 Code [§61(a), 1954 Code]. The *Clifford* case, supra page 372, should be studied again, especially for its explanation of the relation between the catch-all language of §22(a) and the specific language of §§166 and 167 of the 1939 Code [§§676 and 677, 1954 Code]. Was the legislative history adduced by the taxpayer in the *Safe Deposit & Trust Co.* case more compelling than that relied upon by the taxpayer in the *Clifford* case, as footnote 1, supra page 1099, suggests?

Does the *Safe Deposit & Trust Co.* case mean that a *Clifford* trust cannot be included in the grantor's gross estate even though, to quote the *Clifford* opinion, he could not reasonably have "felt himself the poorer after this trust had been executed"? As will be seen, a trust will be part of the grantor's estate if — roughly speaking — he retained the power to alter, amend, or revoke it; if he created it in contemplation of death and died within three years; if he retained a life interest in the income; or if certain other statutory conditions are met. So far, §2033 has not been employed as a method of reaching transfers that escape the technical requirements of these other provisions on the ground that the grantor was still the owner "in substance" of the property. The *Safe Deposit & Trust Co.* case may have dampened the Treasury's enthusiasm, or at least its hopes, for such a use of §2033.* But it is one thing to hold that by requiring property to be included if the decedent *exercised* a general power of appointment, Congress must have intended not to tax it if the power was *unexercised*. It is another thing to assert that the existence of the other specific grounds for taxing transfers (contemplation of death; retained life estates; powers to amend, alter, or revoke; etc.) necessarily means that no other property, except that owned outright by the decedent, may be included in the gross estate.

2. *Other cases.* In Second National Bank of Danville v. Dallman, 209 F.2d 321 (7th Cir. 1954), the decedent was the beneficiary of a policy of insurance on her father's life, under which she was receiving an annuity of 3 per cent of the face amount ($30,000) under a settlement option elected by her father. She was also entitled to designate a "contingent beneficiary" to receive the proceeds of the policy. She did not exercise this power, with the result that the proceeds were paid by the insurance company to her estate under the following provision of the settlement option:

> At the death of the last surviving Beneficiary if there be no Contingent Beneficiary then living, or at the death of the last surviving Contingent Beneficiary occurring subsequently thereto, the amount retained by the Company under Option "A" will be paid to the executors, administrators or assigns of such last surviving Beneficiary or Contingent Beneficiary upon due surrender of this Policy.

The decedent did not mention the insurance proceeds in her will, but her executor paid them over to a trustee under a residuary clause establishing a testamentary trust of "the

* On one occasion, the Supreme Court asked counsel in a pending case to argue the relation of the *Clifford* case to estate tax liability. Estate of Spiegel v. Commissioner, 68 S. Ct. 1522 (1948). The government took the following position in its brief on reargument (p. 53):

". . . Indeed, it is even arguable that a trust covered by the *Clifford* doctrine should be included in the gross estate under [§2033], which in a sense corresponds to the general provisions in [§61(a)] defining gross income. Section [2033] is the basic provision requiring the inclusion in the gross estate of all property owned by the decedent at his death. And where the settlor remains in substance the owner of the trust property for purposes of Section [61(a)] under the *Clifford* case, it is highly persuasive that it should be included in his gross estate under Section [2033], unless there is a specific statute providing otherwise. See Helvering v. Safe Deposit Co., 316 U.S. 56, 58-59. However, the Government has sought in the present cases merely to include these trusts in Section 811(c) [1939 Code]."

The case was decided, as the government intimated it should be, under §811(c) of the 1939 Code, rather than under the general language of §2033. The *Clifford* problem, opened up on the Court's own motion, was discussed only in one of the dissenting opinions; Mr. Justice Burton denied that the doctrine of that case was applicable to estate tax field taxation, but he did not cite the *Safe Deposit & Trust Co.* case. 335 U.S. at 712-718.

rest, residue, and remainder of my estate." The court held that the proceeds were not includible in her gross estate under §2033:

> The government advances theories relative to decedent's control and dominion over the insurance proceeds, which possess more novelty than merit. For instance, the government in its brief states: "From the time of her father's death in 1925, the decedent possessed not only a life estate in the fund but also the remainder interest therein of which she could not be divested except by her voluntary act." Assuming she had a life estate in the fund, which we doubt, such interest was extinguished at her death. In our view, there is no basis for the claim that she possessed a "remainder interest." After the fund had been retained and employed by the insurance company for decedent's benefit during her lifetime, it vested irrevocably and was payable either to the "executors, administrators or assigns" of the decedent or to a contingent beneficiary, depending upon whether decedent during her lifetime exercised her right to select such contingent beneficiary and made such election effective in the manner provided for by the contract. The government in its brief continues: "She could sell, pledge, or assign, in whole or in part, either her life interest or her remainder interest in the fund, or both, to anyone of her own unrestricted choice, including her creditors." If this all-inclusive description of decedent's control or right over the fund means only that she could nominate a contingent beneficiary, we agree. If it means that she had any right or control over the fund other than that, we disagree. The brief continues: "She could and did dispose of her remainder interest by will." It may be true she attempted to do so but her act in that respect was, in our judgment, futile because, for the reasons heretofore shown, it was unauthorized, she was without power to divert the fund by testamentary devise. The novelty of the argument increases as we go along. The brief further states: "In fact, the decedent possessed from the date of death of her father all of the incidents of complete ownership of the fund save only that she could not withdraw the money from the insurance company during her lifetime." It would be more logical to state that decedent during her lifetime possessed none of the incidents of ownership; in fact, she possessed no rights relative to the fund other than those which we have previously stated. . . .
>
> While, as previously noted, no mention was made of the insurance proceeds in decedent's will, it is true under the stipulated facts that such proceeds, together with other property, were turned over by her executor to the trustee designated in her will. Whether the executor had a right to do so is a question not before us and we think it is of no significance. If the decedent had the power by will to direct that the insurance proceeds be paid to a trustee, it would seem logical to conclude that she could have directed payment to Bill Jones, or anybody else. Can there be any rational supposition that the insurance company could have been required to recognize such a direction on the part of the decedent? And the fact is, of course, that the proceeds were paid to the executor not by reason of decedent's will but because of the contractual obligation with her father. Any abortive attempt by decedent to make a disposition of the insurance proceeds effective after her death is not determinative of the issue for decision. The controlling factor is, as we have heretofore attempted to show and which we think is irrefutable, that the decedent was without such power. In Estate of Rogers v. Commissioner, 320 U.S. 410, 413, the court stated, "And that is precisely what the federal estate tax hits — an exercise of the privilege of directing the course of property after a man's death." Here, any attempt by decedent to exercise the privilege (power) to direct the course of the insurance proceeds after her death was of no effect; she was not possessed of power to do so. [209 F.2d at 325-326.]

See also Royce's Estate v. Commissioner, 46 B.T.A. 1090 (1942), in which the government tried to apply the estate tax to property which the decedent had the right to withdraw on demand from a trust created by her husband. Apparently the government thought that the *Safe Deposit & Trust Co.* case was distinguishable because it involved a testamentary power of appointment, while the *Royce* case involved a power exercisable during life. The court held that the decedent had no "interest" in the trust corpus.

3. *References.* Greenbaum, The Clifford Doctrine and the Estate Tax, 6 Tax L. Rev.

312 (1951); Note, Tax Evasion Through Settlement Options: Another Defeat for Substantial Ownership in Estate Taxation, 64 Yale L.J. 137 (1954).

EISENSTEIN, ARE WE READY FOR ESTATE AND GIFT TAX REVISION? *

23 Taxes 316, 323-324 (1945)

There seems to be an impression that an estate tax is congenitally unable to fasten upon property which passes from one trust beneficiary to another, since the decedent has never been full-fledged owner of the property. But this is to assume on the basis of our own limited experience that the deficiencies of the *federal* estate tax must necessarily harass *every* estate tax. In short, substantial change is excluded by freezing the shortcomings of the very status quo which is questioned. However, even if the ingredients of a sturdy estate tax base are to be found in existing tax measures, little is gained by referring to our present estate tax law. For the older British estate tax, which started its career in 1894, has always had special provisions handling property settled in trust. However, as I see it, we should think things and not words. The important thing is not to search for certain so-called intrinsic characteristics or limitations of an estate tax, but to determine, as a matter of policy, the requirements of an effective and equitable estate tax, regardless of the particular scheme of disposition. An estate tax is what we make it. One need not bow to any inner compulsion of semantics.

The vital fact is that under the present federal estate tax, property which passes by outright disposition bears a far heavier tax load than property which moves along paths charted in advance by a trust. How can this condition be met? I am going to mention four possible approaches. Although these four hardly exhaust the alternatives which compete for recognition, they seem to provide a sturdy framework of reference even if individual tastes may differ quite violently.

The first possibility is to impose an additional tax upon the initial disposition in trust to compensate for the interim loss of revenue as a result of the settlement in trust. In considering this approach, it is well to remember that we are not entirely in the realm of theory. As I have already suggested, the English, unlike ourselves, were acutely conscious of the avoidance potentialities of the trust device and imposed in their original act of 1894 an additional tax — called a Settlement Duty — upon dispositions in trust. The purpose of this duty was to equalize, in rather rough fashion, the total burden, over several generations, borne by property in trust and property passing outright. This additional duty, however, was abandoned in 1914 because it failed to attain its objective. From our own point of view, I think there are three difficulties which should be noted. In the first place, the compensatory levy might have to be so high in order to attain an equivalence in burden that it would be politically unfeasible. Second, the additional tax would fail to differentiate between different trusts on the basis of successive shifts in beneficial enjoyment. Finally, a levy upon the disposition in trust would enable all successions under outstanding trusts to escape tax. I have never been able to understand why the early bird should necessarily catch the worm when the tax laws are strengthened and improved. An initial error is hardly a remorseless excuse for creating a vested interest in the error under cover of the Constitution.

The present English law offers us a second possibility, namely, to tax the property when the beneficial enjoyment shifts from one person to another. Hence, upon the death of the life tenant, the property would be included in his gross estate. Undoubtedly this treatment of trusts is at variance with established no-

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tions for, after all, the life tenant, who has never owned the property, is accorded the status of owner at death. I will by-pass the constitutional question, although I would like to mention the Supreme Court's recent admonition that it is sufficient for estate tax purposes "that one person acquires economic interests in property through the death of another person; even though such acquisition is in part the automatic consequence of death." Whitney v. State Tax Commission, 309 U.S. 530, 538 (1940). The important question at present is one of policy — to determine the appropriate tax treatment. While the constitutional issues are obviously serious, we may worry about constitutional doctrine once we have decided what to do. It may nevertheless appear unjust to tax the life tenant as if he were owner. Tax law, however, is no exception to the rule that "the right answer usually depends on putting the right question." Estate of Rogers v. Commissioner, 320 U.S. 410, 413 (1943). If the crucial question is how to devise a levy which is geared to the decedent's quantum of ownership, then the English system is undoubtedly on the wrong track. If, on the other hand, the question is one of implementing the estate tax so that, regardless of the particular type of disposition, it takes the same periodic bite out of property as it moves from one generation to another, the British estate tax is clearly on the right track.

A third alternative is more modest than the English statute. Our problem would be approached from the taker's side of the transfer by imposing a supplementary accessions tax upon the remainder when it falls in. The major practical distinction between this type of tax and the English method is that the former would not aggregate the remainder together with the life tenant's individual property. The tax base would be composed entirely of the remainder out of which the tax would be paid. Dispositions in trust would still enjoy tax benefits although they could be somewhat curtailed, depending upon the rate. A supplementary accessions tax, which is essentially a modified inheritance tax, naturally raises the question of handling accessions which are not absolute in character. For example, to take a simple case, suppose the initial life estate is followed by another before the remainder materializes in possession and enjoyment. The tax upon the second life estate could be determined in a variety of ways. It might be imposed upon commencement of the tenancy and be based upon the actuarial value of the interest as under an inheritance tax; it might be collected on a pay-as-you-go basis as the income was received, with a rate progression akin to that of the gift tax; or it might be computed at the termination of the tenancy, when the period of enjoyment was already a matter of history rather than prediction. The difficulties of valuation would of course increase as the contingencies became more complicated, and the complexities could easily pass beyond the recognized limitations of the art of valuation.

The valuation problems posed by a supplementary accessions tax lead very easily and naturally to the fourth possibility. Instead of imposing an accessions tax, Congress might enact a supplementary estate tax which would apply to property passing in accordance with a settlement in trust made by another. As an estate tax, the levy would avoid the valuation complexities just noted, since the tax would be laid upon the transfer of beneficial enjoyment and not upon the taker's receipt. The tax would be distinguishable from the British death duty in that the trust property would not be aggregated with the decedent's individual assets. A supplementary estate tax of this type would fit very snugly into our present system and its established concepts. It would not, however, attain the equivalence of the British system.

NOTE

1. *The life estate in estate planning.* The principal practical difficulties in employing the dispositive pattern of a life estate in children, remainder to grandchildren, as a device to avoid a generation of estate taxation are two:

(1) The family fortune may not be large enough to take care of the children if they are given only a life estate. For this reason, the life-estate-remainder sequence is most useful in precisely those circumstances where it most reduces the tax burden — for a very large family fortune.

(2) Ordinarily the children, rather than the grandchildren, are the primary object of the testator's solicitude. Consequently, even if the fortune is large, he may be fearful of a shrinkage that will squeeze the life tenants. The remedy is to give them the right to invade corpus. But if the right is unfettered, it will be a "general power of appointment" under §2041, and (if created after 1942) it will bring the property into the life tenant's estate even if he dies without exercising it. As is seen infra page 1267, however, under today's law the life tenant can be endowed with certain restricted powers to invade corpus (in the event of extraordinary medical expenses; up to $5000 per year; etc.) without bringing the corpus into his gross estate. Another possibility, which may adequately protect the life tenant even though it gives him less independence, is to vest the power to advance corpus in a third person.

2. *References.* Surrey, An Introduction to Revision of the Federal Estate and Gift Taxes, 38 Calif. L. Rev. 1, 18-23 (1950); Young, Estate Planning and the Tax Structure, 1963 U. of Ill. L.F. 437, 442-449.

SECTION C. DOWER AND CURTESY, COMMUNITY PROPERTY, AND THE MARITAL DEDUCTION

1. *Dower, Curtesy, and Statutory Substitutes Therefor*

Section 2034, providing that the gross estate shall include all property to the extent of the surviving spouse's interest as dower, curtesy, or statutory substitute therefor, buttresses §2033 (property owned at death) by preventing the gross estate from being reduced by the value of the surviving spouse's dower or similar marital rights. For the treatment of dower and curtesy before the enactment of §2034 in 1918, see Randolph v. Craig, 267 Fed. 993 (M.D. Tenn. 1920); Schuette v. Bowers, 40 F.2d 208 (2d Cir. 1930).

It has been argued that the inclusion of dower in the gross estate is unconstitutional. The argument: (a) The wife's dower interest arises as an incident of her marriage, not from her husband's death; (b) therefore, there is no "transfer" at the time of her husband's death; (c) therefore, the tax is imposed not upon a transfer but upon the surviving wife's "property"; (d) therefore, the tax is not an excise but a "direct" tax; (e) therefore, the tax violates Sections 2 and 9 of Article I of the Constitution, which require that direct taxes be apportioned among the several states according to their population. The weak links in the syllogism are of course points (a) and (b); in upholding the tax, the Court of Appeals for the Eighth Circuit said, in Allen v. Henggeler, 32 F.2d 69, 72 (1929), cert. denied, 280 U.S. 594:

> . . . Giving full weight to the Nebraska court's description of the wife's interest, the facts still remain that the husband has at least the following very substantial rights in such property:
>
> He has the exclusive right of possession; the exclusive right to the income incident thereto; all of it can be taken for his debts; he has therefore the exclusive right to use

it as a basis for credit; he has the right to have it all applied to the payment of his debts upon his death; as to the personal property, he has the further and exclusive right of transfer and disposition and of gift, and can likewise convey real estate if his wife is not a resident of Nebraska; he has the power to convey real estate, without his resident wife's signature, and put his purchaser into possession, and, if his wife predeceases him, the title is absolute. He has every right of ownership, save that he cannot will it without her consent; and, as to real estate with a resident wife, his deed is conditioned on him outliving her; and, perhaps, he cannot give away or dissipate property in fraud of her.

These rights of the husband are among the most valuable incidents of ownership. The right of possession and enjoyment of the income, the right to use it as a basis for credit, and the right to pay his debts with it, are most important attributes of ownership. And these are all "interests" which he enjoys in his own property, under the statutes and decisions of Nebraska and which cease at his death.

As a matter of fact, the Nebraska statutes and decisions are very much like those of many other states, and it is matter of common knowledge that a widow has much greater rights in her one-third or one-half, as the case may be, after death than she does before. Upon the death of her husband, she "comes into" her property. The very substantial rights which her husband has in the one-third cease at his death.

Accord: Nyberg v. United States, 66 Ct. Cl. 153 (1928), cert. denied, 278 U.S. 646; Mayer v. Reinecke, 130 F.2d 350 (7th Cir. 1942), cert. denied, 317 U.S. 684. Although the Supreme Court has never directly passed on the constitutionality of §2034, its validity is assumed in Merrill v. Fahs, supra page 1027, and follows a fortiori from the reasoning of Fernandez v. Wiener, infra page 1107.

H, pursuant to an antenuptial agreement, created an irrevocable trust in favor of W for her life and in his will gave her the equivalent of her dower rights less the value of the trust. The Commissioner included the value of the trust in the gross estate, arguing that §2034 "should be construed to include not only interests in lieu of dower created by statute, as that section directs, but also any interest in lieu of dower created by the decedent." The court refused to adopt this construction, as it would "extend the application of [§2034] far beyond its terms" and beyond the construction of the section in the Regulations (Regs. §20.2034-1). Estate of Byram v. Commissioner, 9 T.C. 1 (1947).

Property transferred "in contemplation of death" (a phrase examined in detail infra p. 1121) is part of the gross estate, "except in case of a bona fide sale for an adequate and full consideration in money and money's worth." §2035. If H gives W $100,000 in contemplation of death, the sum will be part of his gross estate, though the money is W's absolutely — indeed, even though it has been spent — long before H's death. If a transfer is made for full and adequate consideration (e.g., as payment for property), however, the transferred property is not brought back into H's gross estate. What if the transfer, though in contemplation of death, was in return for W's release of her dower? Since the Revenue Act of 1932, the statute has expressly provided that a relinquishment of dower, curtesy, or similar rights shall not be considered as consideration in money or money's worth. See §2043(b), the history of which was set out in Merrill v. Fahs, supra page 1027, see also Empire Trust Co. v. Commissioner, 94 F.2d 307 (4th Cir. 1938); Ferguson v. Dickson, 300 Fed. 961 (3d Cir. 1924), cert. denied, 266 U.S. 628; McCaughn v. Carver, 19 F.2d 126 (3d Cir. 1927).

2. *Community Property*

Although the federal estate tax disregards the surviving spouse's dower, curtesy, or similar interests in computing the decedent's gross estate, the treatment of the surviving spouse's interest in community property has been very different. As early as 1919, the Attorney General ruled that only one half of the value of

community property was includible in the gross estate of the first spouse to die. T.D. 3138, 23 Treas. Dec. Int. Rev. 238 (1921); T.D. 2450, 19 id. 38 (1919). The ruling was predicated on the nature of community property: each spouse is regarded as having a vested interest in one half throughout the marriage, and the first spouse to die has testamentary power over his or her one half only. See Poe v. Seaborn, supra page 330; de Funiak, Principles of Community Property (1943), §§1, 102, 113; de Funiak, A Review in Brief of Principles of Community Property, 32 Ky. L.J. 63 (1943). Other observers, however, have thought that the husband's control over both halves of the community property during the marriage was so substantial that it would be appropriate to include the entire property in his gross estate if he was the first to die. See Eisenstein, Estate Taxes and the Higher Learning of the Supreme Court, 3 Tax L. Rev. 395, 538-540 (1948).

In 1942, Congress concluded that the legal and economic differences between the common law and community property systems did not justify the substantial difference in their federal tax burdens, and moved to equalize their estate tax consequences* by requiring the entire amount of the community property to be included in the gross estate of the first spouse to die "except such part thereof as may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse." Even if the community property was entirely attributable to the surviving spouse's personal services or separate property, however, the 1942 amendment required one half to be included in the gross estate of the spouse who died first because of his or her testamentary power over that half.

The constitutionality of the 1942 amendment was attacked, and upheld, in Fernandez v. Wiener, 326 U.S. 340 (1945). In a lengthy opinion, the Supreme Court (per Chief Justice Stone) said:

> Appellees' argument is in substance that the nature of community property is such that husband and wife each has, by virtue of the establishment of their marital community, and from its beginning, a present half interest in such property; that the death of either effects no transfer or relinquishment of any interest in the property other than that of the half share which the decedent had before his death; and that the survivor in consequence of the death of the other spouse acquires no new or different interest in the property, but only retains the half share he or she had prior to the death of the other spouse. From this appellees conclude that the death of either spouse is not an event which in any case can bring more than one-half of the community property within the reach of the power to "lay and collect . . . imposts and excises" conferred on Congress by Article I, §8 of the Constitution, and that the present amendment taxing the entire value of the community property on the death of either spouse is a denial of due process because the death of neither operates to transfer, relinquish or enlarge any legal or economic interest in the property of the other spouse. Hence it is said that the statute infringes due process by adding to the concededly valid tax on the decedent's half share a further tax measured by the one-half interest of the surviving spouse. Further, it is urged in support of the due process contention, that the statute arbitrarily and capriciously invents different rules of taxation whose alternative application is governed by a single consideration, namely, which will yield the greater tax; and that the statute creates a presumption contrary to state law, and having no rational basis in fact, that the entire community is owned or economically attributable to the spouse first to die. It is also argued that even if Congress could validly impose the tax where, as here, the husband is first to die, there is no basis for the tax where the wife dies first, and that since the statute purports to apply in either case, and is not separable, it cannot be validly applied in this.
>
> It is also contended that the tax is not uniform as required by Article I, §8, Clause 1

* As indicated infra page 1110, no change in the income tax advantages of the community property system was made in 1942, and, despite the loss of its estate tax appeal, it began to move eastward.

of the Constitution, because the joint interests of husband and wife in community property states are taxed according to a different and more onerous standard than is applied to comparable joint interests, and specifically to tenancies in common and limited partnerships, created under the laws of other states in which the presumption is not applied; and because the statute disregards for purposes of taxation the property laws of the community property states, while recognizing the property laws of other states for those purposes.

It is said too that the levy is a direct tax, invalid because not apportioned (Article I, §9, Clause 4 of the Constitution), insofar as it contemplates collection of part of the tax out of the wife's half of the community property, since, it is said, there is no excisable event touching her property on her husband's death and the tax collected out of her property is in effect a direct tax upon it. And finally the tax is said to invade the powers reserved to the states by the Tenth Amendment, to determine property relationships within their borders.

The merits of these contentions cannot be accurately appraised without some inquiry as to the nature of respective spouses' community property interests as defined by Louisiana law. . . . As we have seen, the death of the husband of the Louisiana marital community not only operates to transfer his rights in his share of the community to his heirs or those taking under his will. It terminates his expansive and sometimes profitable control over the wife's share, and for the first time brings her half of the property into her full and exclusive possession, control and enjoyment. The cessation of these extensive powers of the husband, even though they were powers over property which he never "owned," and the establishment in the wife of new powers of control over her share, though it was always hers, furnish appropriate occasions for the imposition of an excise tax.

Similarly, with the death of the wife, her title or ownership in her share of the community property ends, and passes to her heirs or other appointees. More than this, her death, by ending the marital community, liberates her husband's share from the restrictions which the existence of the community had placed upon his control of it. He acquires by her death, the right to have his share of the community separated from hers by partition, and to hold it free of all controls. He obtains, for the first time, the right to give away his immovables, and the right to give away his movables as a whole or by a fraction of the whole. Here too, the wife's death brings into being a new set of relationships with respect to his share of the community as well as hers, among which are new powers of control and disposition which are proper subjects of an excise tax measured by the value of his share. And while we do not rest decision on the point, it is of some significance that this shift of legal relationships effects a shift in point of economic substance. The precept that the wife is equal co-owner with her husband of community property undoubtedly calls into play within the marital relationship personal and psychological forces which have great importance in the practical determination of how community property shall be managed by the husband. Though it may be impossible fully to translate these imponderables into legal rules, the death of the wife undoubtedly brings, in every practical aspect, greater freedom to the husband in his disposition of that share of community property which is technically his, than is to be gathered solely from a reading of statutes and case law. . . .

What we have said of the nature and incidence of the tax on community property in large measure disposes of the various other contentions of appellees. Since the levy is an excise and not a property tax, the case is not one of taking the survivor's property to pay the tax on decedent's estate. As the tax is upon the surrender of old incidents of property by the decedent and the acquisition of new by the survivor, it is appropriately measured by the value of the property to which these incidents attach. The tax burden thus laid is not so unrelated to the privileges enjoyed by the taxpayers who are owners of the property affected that it can be said to be an arbitrary exercise of the taxing power. . . . While it may generally be true, as appellees argue, that neither the husband nor wife gains any over-all financial advantage when the other dies, it suffices that the decedent loses and the survivor acquires, with respect to the property taxed, substantial rights of enjoyment and control which may be of value. Liability to the tax, in order to avoid constitutional objection, does not have to rest upon the enjoyment by the taxpayer of all

the privileges and benefits of the most favored owner at a given time and place. Corliss v. Bowers, 281 U.S. 376; Reinecke v. Smith, 289 U.S. 172; cf. Burnet v. Guggenheim, 288 U.S. 280.

We find no basis for the contention that the tax is arbitrary and capricious because it taxes transfers at death and also the shifting at death of particular incidents of property. Congress is free to tax either or both, and here it has taxed both, as it may constitutionally do, in order to accomplish "the purposes and policy of taxation" to protect the revenue and avoid an unequal distribution of the tax burden.

Even if it could be thought to affect the constitutionality of the taxing statute, it is plain that the statute does not depend for its operation upon any presumption that the entire community property is owned or economically attributable to the spouse first to die. Save as the statute itself grants an exemption by such attribution, so far as the community property "may be shown to have been received as compensation for personal services actually rendered by the surviving spouse or derived originally from such compensation or from separate property of the surviving spouse," the tax is laid without regard to the economic source of the community property. Apart from the exemption, it is, as we have seen, the shifting at death of the incidents of the property, regardless of origin, which is the subject of the tax. . . .

Appellees suggest that interests in tenancies in common and limited partnerships are very like interests in community property, and that if the tax is to be uniform, the one cannot be taxed unless the others are also. But even if it be as appellees argue, that common law family partnership or other arrangements with different names can be so devised that the marital relationship is attended by the same powers and restrictions as those derived from the laws of the community property states, and that they are differently or more lightly taxed than community property interests, we find no lack of uniformity in the constitutional sense. The present amendment is geographically uniform in its application to the only subject of which it treats, community property interests, and it levies in every state an identical tax upon the subject matter included within its terms— defined property interests created by state law, having a common historical origin, a common name, and constituting a universally recognized distinct class of property interests. . . .

An excise tax, which the Constitution requires to be uniform, laid upon the shifting at death of some of the incidents of property, could hardly be thought to be a direct tax which must be apportioned. See Bromley v. McCaughn [280 U.S. 124], 138. The contention that such a tax is direct because measured by the property whose incidents are shifted at death, was rejected in Bromley v. McCaughn, supra, and in Tyler v. United States [281 U.S. 497], 501-4, and Phillips v. Dime Trust Co., 284 U.S. 160, 165. A tax imposed upon the exercise of some of the numerous rights of property is clearly distinguishable from a direct tax, which falls upon the owner merely because he is owner, regardless of his use or disposition of the property. "The persistence of this distinction and the justification for it rest upon the historic fact that [excise] taxes of this type were not understood to be direct taxes when the Constitution was adopted and, as well, upon the reluctance of this Court to enlarge, by construction, limitations upon the sovereign power of taxation by Article I, §8, so vital to the maintenance of the national government." Bromley v. McCaughn, supra, 137.

The Tenth Amendment does not operate as a limitation upon the powers, expressed or implied, delegated to the national government. United States v. Darby, 312 U.S. 100, 123-4. The amendment has clearly placed no restriction upon the power delegated to the national government to lay an excise tax qua tax. Undoubtedly every tax which lays its burden on some and not others may have an incidental regulatory effect. But since that is an inseparable concomitant of the power to tax, the incidental regulatory effect of the tax is embraced within the power to lay it. It has long been settled that an Act of Congress which on its face purports to be an exercise of the taxing power, is not any the less so because the tax is burdensome or tends to restrict or suppress the thing taxed. In such a case it is not within the province of courts to inquire into the unexpressed purposes or motives which may have moved Congress to exercise a power constitutionally conferred upon it. Sonzinsky v. United States, 300 U.S. 506, 513-514, and cases cited. [326 U.S. at 346-362.]

In a concurring opinion, Mr. Justice Douglas, joined by Mr. Justice Black, said:

> Much may be said for the community property theory that the accumulations of property during marriage are as much the product of the activities of the wife as those of the titular bread-winner.* . . . But I can see no reason why that which is in fact an economic unit may not be treated as one in law. For as Mr. Justice Holmes pointed out in his dissent, there is a community of interest "when two spouses live together and when usually each would get the benefit of the income of each without inquiry into the source." And he went on to say "Taxation may consider not only command over, but actual enjoyment of, the property taxed." 284 U.S. pp. 219-220. Cf. Helvering v. Clifford, 309 U.S. 331, 335-337.
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> The Congress has not gone the full distance here. It has not included in one estate all the property owned by husband and wife.† . . . Congress, to be sure, has disregarded the manner in which Louisiana divided "ownership" of property between husband and wife. But as between husband and wife, notions of "vested interests," "ownership," and the like, established by local law, are no sure guide to what "belongs" to one or the other in any practical sense. We would be blind to the usual implications of the intimate relationship of marriage if we forced Congress to treat such divisions of "ownership" the same way it does divisions of "ownership" among strangers. I find no such compulsion in the Constitution. [326 U.S. at 365-366.]

The provision of the Revenue Act of 1942 that was upheld by the Supreme Court in Fernandez v. Wiener concerned the estate tax consequences of community property. The same legislation attempted to equalize the community property and common law systems in the federal gift tax field by requiring a gift of community property to be treated as a gift by the husband unless it was attributable to the wife's personal services or separate property. The constitutionality of this provision was upheld on the authority of Fernandez v. Wiener in Francis v. Commissioner, 8 T.C. 822 (1947), and Beavers v. Commissioner, 165 F.2d 208 (5th Cir. 1947), cert. denied, 334 U.S. 811.

3. *The Marital Deduction and Split Gift Provisions of the Revenue Act of 1948*

The 1942 legislation left intact the income tax advantages of community property, with the result (described supra p. 332) that the community property system began to spread to the east and north of its historic area. Finally, when Congress decided in 1948 to attack the income tax disparity between the two property systems by authorizing the income-splitting joint return, rather than by requiring the income from community property to be reported by the spouse whose personal services or separate property created it, the way was cleared for an abandonment of the "economic source" approach of the 1942 estate and gift tax provisions. In short, Congress was persuaded in 1948 to follow the income tax equalization route of extending the delights of community property to common law property, in substitution for the converse philosophy of the 1942 legislation. The arguments for doing so were summarized by the Senate Finance Committee, in recommending enactment of the Revenue Act of 1948, as follows:

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* Occasionally a couple in a common law state succeeds in establishing that the property accumulated by them during marriage is held in an informal partnership because they both contributed capital and services to a family business with a tacit understanding that the profits and losses would be shared equally. For an example of this type of do-it-yourself community property, see United States v. Neel, supra page 1081, holding that only one half of such property was owned by the husband within the meaning of §2033. — Ed.

† On the constitutional propriety of including all of the community property, plus all of the separate property, in the gross estate of the first spouse to die, see Eisenstein, Estate Taxes and the Higher Learning of the Supreme Court, 3 Tax L. Rev. 395, 549-561 (1948). — Ed.

Unfortunately, a number of problems have arisen under the 1942 amendments. Most important of these is the fact that geographical equalization has not been realized in a typical situation. Furthermore, the problem of determining the economic contribution of the surviving spouse to the community has resulted in an extremely difficult problem of "tracing." Severe hardship also results where, because the entire community property is includible in his gross estate, the estate tax of the decedent is larger than the community property subject to his power of disposition. For example, if a decedent is economically responsible for the entire community this average tax rate on his estate may exceed 50 per cent. However, only half of the community is subject to his power of disposition. Thus the share of the community already belonging to his spouse may be required to bear part of the tax although the spouse does not inherit any property under State law.

The most obvious instance of the failure to attain equalization results from the widespread use of life tenancies in the common-law States. In this situation, the husband transfers or bequeaths to his wife a life estate, with remainder over to the children. At his death the whole of the estate is taxed, but at the wife's death there is no tax on the cessation of her life estate. On the other hand, in a community-property State, the husband may not by his will dispose of his wife's interest in community property. If he bequeaths his one-half interest in the community to his wife for life with remainder over to the children, the entire community may be included in his gross estate, and on the death of the wife, one-half the community is also included in her estate. Thus the common-law couple is subject only to a single transfer tax, whereas the community-property couple pays two transfer taxes, one on an estate of equal size and one on an estate of half the size of that passing in the common-law State.

The "tracing problem" arises under the 1942 amendments because of the need for identifying portions of the community contributed by each spouse. Establishing the fact that particular assets of the community are derived from "compensation for personal services actually rendered by the survivor . . . ," is impossible in a great many situations. Under the 1942 amendments this tracing problem is of far larger dimensions in community-property States than in common-law jurisdictions, where it is limited primarily to joint tenancies, tenancies by the entirety, and joint bank accounts.

Your committee does not believe that a satisfactory solution to the problem of geographical equalization or the difficulties of tracing can be found under the 1942 amendments or amendments using a similar theoretical approach. Hence the repeal of these amendments is recommended, effective with respect to gifts made after the date of enactment of this bill and with respect to the estates of decedents dying after the date of such enactment. Your committee would be unwilling, however, merely to repeal the 1942 amendments. Repeal alone would reproduce the pre-1942 results, which are even further from equalization than existing law.

With the repeal of the 1942 amendments your committee recommends estate and gift tax splitting which is similar in its effects to the splitting of the income tax provided for in this bill. It is recognized that complete equalization of the estate and gift taxes can not be achieved because of the inherent differences between community property and noncommunity property. However, the new provisions will result in equality in the important situations.

Under the estate-tax provision of your committee's bill a decedent spouse is allowed a marital deduction from his gross estate in the amount of the value of all interests in property passing outright from the decedent to the surviving spouse by way of bequest, devise, transfer, right of survivorship in jointly held property, etc. The deduction is limited to an amount not in excess of 50 per cent of the adjusted gross estate.

Under the gift-tax provisions of your committee's bill a donor spouse is allowed a deduction for every outright transfer by gift to his spouse, such deduction to be an amount equal to one-half of the value of the interest transferred. In the case of a transfer by gift by a married person to persons other than his spouse, the interest transferred may be considered as made one-half by each, if the spouses so elect.

Under both the estate and gift taxes the marital deduction does not apply to the decedent's or the donor's interest in community property. This exception was necessary because after the repeal of the 1942 amendments the surviving spouse in a community property State will receive one-half of the community property tax-free. Similarly, a donor

spouse will be taxable on only one-half the value of any gifts made out of the community property. Although the marital deduction does not apply to community property, it will apply, in general, to the separate property of a decedent or a donor in a community-property State.

In the preceding paragraphs it has been stated that the interest in property must pass outright to the surviving or donee spouse to qualify for the marital deduction. This is intended to restrict the deduction to those cases where the decedent or donor passes to his spouse all of his interest in the property. This will equate the decedent in the common-law State with the decedent in the community-property State who cannot by his will effect in any way the surviving spouse's interest in the community property. Thus, a deduction will not be allowed under the amendments if the only interest given a spouse is in property in which the decedent or donor also gave an interest to some one else who may possess or enjoy the property after the donee spouse dies. However, if the only interest the husband has in the property is a terminable interest, such as a lease, and he gives his wife his entire interest in the property, then the deduction is permitted.

Among the exceptions to this rule is the recognition of one of the customary modes of transfer of property in common-law States. The deduction is applicable where the decedent or donor creates a trust, the income of which the beneficiary or donee spouse is entitled to for his life, with a taxable power of appointment over the corpus of such trust in the spouse. Thus the property subject to the taxable power of appointment will be includible in the gross estate of the beneficiary or donee spouse unless it has been dissipated in the interval. [S. Rept. No. 1013, 88th Cong., 2d Sess., reprinted in 1948-2 C.B. 285, 304-305.]

President Truman vetoed the proposed Revenue Act of 1948 on the ground that "nearly all of the $250,000,000 annual reduction would go to only about 12,000 of the most wealthy families," saying also that the 1942 legislation achieved equalization between community property and common law states in the estate and gift tax areas "in all essential respects." The bill was passed over his veto on April 2, 1948.

NOTE

1. *The 1948 marital deduction and split gift provisions.* Aside from its revenue effects, the marital deduction created by the 1948 legislation, and now embodied in §2056, has drastically affected the process of estate planning and the drafting of wills. Its complex provisions are considered infra page 1286. For the correlative marital deduction allowed by §2523 in computing the taxable amount when a gift is made by one spouse to the other and the "split gift" device of §2513, under which a gift by a married person to a third person may be treated as made one half by him and one half by his spouse, see page 1320 infra.

2. *Community property and the estate tax.* As the Senate Finance Committee Report quoted supra stated, the 1942 estate and gift tax provisions created a "tracing problem" for married couples owning community property. Thus, if both H and W invested separate property in a business and then performed services without drawing salaries, the assets on the death of one would have to be allocated, under the 1942 provisions, among four categories: (1) decedent's separate property; (2) survivor's separate property; (3) community property earned by decedent; and (4) community property earned by survivor. Categories (1) and (3) would be taxed to decedent's estate. See Neumann's Estate v. Commissioner, 9 T.C. 1120 (1947). Even after the 1948 repeal of the 1942 amendments, it is necessary to allocate such assets among three categories: (1) as above; (2) as above; and (3) community property. This, of course, is because 100 per cent of (1) but only 50 per cent of (3) is includible in the decedent's estate. Is this allocation substantially less onerous than that required by the 1942 provisions? See Duncan v. United States, 247 F.2d 845 (5th Cir. 1957); Vogel's Estate v. Commissioner, 278 F.2d 548 (9th Cir. 1960).

3. *Community property and the gift tax.* How is gift tax liability to be computed on a gratuitous transfer of community property to a third person? As to the husband's power to make a gift of community property without his wife's consent, see de Funiak,

Principles of Community Property, Section 122 (1943); Coulter, Limitations on the Power of a Community Manager to Make Gifts of Community Property, 28 Ore. L. Rev. 210 (1949).

Is there a gift tax on the conversion of community property into the separate property of H or W? On the conversion of separate property into community property? Is the $3000 exclusion applicable in the latter instance? Roeser v. Commissioner, 2 T.C. 298, 303 (1943); Perkins v. Commissioner, 1 T.C. 982 (1943); Damner v. Commissioner, 3 T.C. 638 (1944).

4. *References*. Thurman, Federal Estate and Gift Taxation of Community Property, 1 Ariz. L. Rev. 253 (1959); Jackson, Community Property and Federal Taxes, 12 Sw. L.J. 1 (1958).

SECTION D. JOINTLY HELD PROPERTY: §2040

In Tyler v. United States, 281 U.S. 497 (1930), the Supreme Court upheld as constitutional §202(c) of the Revenue Act of 1916, which was the forerunner of §2040 of the 1954 Code, as applied to a tenancy by the entirety created after the statute was enacted. The Court held that the tax was an excise, not an unapportioned direct tax:

> The question . . . is, not whether there has been, in the strict sense of that word, a "transfer" of the property by the death of the decedent, or a receipt of it by right of succession, but whether the death has brought into being or ripened for the survivor, property rights of such character as to make appropriate the imposition of a tax upon that result (which Congress may call a transfer tax, a death duty or anything else it sees fit), to be measured, in whole or in part, by the value of such rights. . . .
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> At . . . [the co-tenant's] death . . . and because of it, . . . [the survivor] for the first time, became entitled to exclusive possession, use and enjoyment; she ceased to hold the property subject to qualifications imposed by the law relating to tenancy by the entirety, and became entitled to hold and enjoy it absolutely as her own; and then, and then only, she acquired the power, not theretofore possessed, of disposing of the property by an exercise of her sole will. Thus the death of one of the parties to the tenancy became the "generating source" of important and definite accessions to the property rights of the other. These circumstances, together with the fact, the existence of which the statute requires, that no part of the property originally had belonged to the wife, are sufficient, in our opinion, to make valid the inclusion of the property in the gross estate which forms the primary base for the measurement of the tax. [281 U.S. at 503-504.]

In Third National Bank & Trust Co. v. White, 287 U.S. 577 (1932), the Court affirmed, per curiam, a judgment applying the same principle to a pre-1916 tenancy by the entirety.

Where property is held in joint tenancy, rather than in tenancy by the entirety, either co-tenant can terminate the tenancy and get one half of the property, provided he acts while the other co-tenant is living. Despite this possibility of a severance, the Supreme Court has upheld the application of what is now §2040 to property held in joint tenancy, whether the tenancy was created after or before 1916. See United States v. Jacobs, 306 U.S. 363, 369-371 (1939):

> Since a joint tenant's interest in realty is severable and subject to sale, the argument is that upon the death of a co-tenant the survivor actually receives nothing more than the decedent's one-half interest and therefore no more can be subjected to a death duty. On the other hand, respondent explains the permissible taxation of the whole of a tenancy by the entirety by reference to the "amiable fiction" of the common law, under which ownership of a husband and wife in tenancy by the entirety is deemed a single individual unity and each owns all and every part of the property so held. By virtue of this feudal fiction of complete ownership in each of two persons, the surviving tenant

by the entirety is conceived to be the recipient of all the property upon the death of the co-tenant, and therefore — it is said — all the property can be taxed.

The constitutionality of an exercise of the taxing power of Congress is not to be determined by such shadowy and intricate distinctions of common law property concepts and ancient fictions. . . .

While it is true that until the death of decedent here each joint tenant possessed the right to sever the joint tenancy, each was nevertheless subjected to the hazard of losing the complete estate to the other as survivor. Prior to decedent's death, his wife had no right to dispose of her interest by will, nor could it pass to her legal heirs. She might survive and thereby obtain a complete fee to the property with attendant rights of possession and disposition by will or otherwise. Until the death of her co-tenant, the wife could have severed the joint tenancy and thus have escaped the application of the estate tax of which she complains. Upon the death of her co-tenant she for the first time became possessed of the sole right to sell the entire property without risk of loss which might have resulted from partition or separate sale of her interest while decedent lived. There was — at his death — a distinct shifting of economic interest, a decided change for the survivor's benefit. This termination of a joint tenancy marked by a change in the nature of ownership of property was designated by Congress as an appropriate occasion for the imposition of a tax. Neither the amount of the tax nor its application to the survivor's change of status and ownership, was in any manner dependent upon the date of the joint tenancy's creation, whether before, or after 1916. It is immaterial that Congress chose to measure the amount of the tax by a percentage of the total value of the property, rather than by a part, or by a set sum for each such change. The wisdom both of the tax and of its measurement was for Congress to determine.

What are the economic differences between a tenancy by the entirety and a joint tenancy? Are they "shadowy and intricate"? Do they warrant divergent tax treatment? On the constitutional issues, see Eisenstein, Estate Taxes and the Higher Learning of the Supreme Court, 3 Tax L. Rev. 395, 408-421 (1948).

The Regulations state that §2040 "has no application to property held by the decedent and any other person (or persons) as tenants in common." Regs. §20.2040-1(b). How *is* property held in a tenancy in common to be treated when one of the tenants dies?

HARVEY v. UNITED STATES

185 F.2d 463 (7th Cir. 1950)

Before MAJOR, Chief Judge and DUFFY and LINDLEY, Circuit Judges.

LINDLEY, Circuit Judge.

Plaintiff, as executrix of the estate of her deceased husband, Arlington C. Harvey, filed an estate tax return showing no tax due. The Commissioner assessed a deficiency in the amount of $32,151.30, which, with interest, she paid under protest. Her claim for refund having been rejected, she instituted suit in the District Court for recovery of the tax paid and obtained judgment. The principal contention of the government on appeal is that the trial court erred in deciding that certain property held by plaintiff and her husband in joint tenancy came within the scope of the exception contained in [§2040, relating to property that "originally belonged" to the survivor], and, consequently, was not part of the decedent's taxable estate. . . .

The tax return disclosed that the decedent was, at the time of his death, joint owner with his wife of property of the value of $200,709.78. Plaintiff asserted the right to deduct $143,450 from the gross value, because of contributions made by the wife, out of "funds and property separately owned" by her, in acquisition of the jointly held property. However, the Commissioner determined that the entire value of the jointly owned property, $201,859.78, should be included in the

decedent's gross estate, on the basis of his finding that all of the property was held in joint tenancy and that no part thereof had been shown to have belonged originally to the wife and never to have been received or acquired by her from the decedent for less than an adequate consideration in money or money's worth.

The stipulation of facts and the District Court's findings disclose that the decedent had, from time to time, made gifts of money and property to his wife, which, through successive investments, sales and reinvestments with resulting gains, had been transmuted into other property. The wife was at no time gainfully employed and had no property at the time of her marriage. In other words, the only assets acquired or owned by her were those given her by her husband, plus the profits and income produced by them, in either their original or converted forms, and the wife's contributions toward acquisition of the property which she held in joint tenancy with her husband at the time of his death, of necessity, emanated from these sources. The jointly held property is not the gift property itself, in either its original or transmuted form, but property traceable to (1) the profits made through sales of the original gift property and successive reinvestments of the proceeds of such sales or (2) the rents, interest and dividends produced by such property in its original or converted form, while title thereto was in the wife. The question presented by this appeal, then, is whether such profits and income, realized from property originally received by the wife as a gift from her husband and traceable into property which was held by them as joint tenants at the time of the husband's death, came within the exception to the requirement of [§2040] that the entire value of property held in joint tenancy shall be included in the decedent's gross estate. . . .

If the government's contention that the Commissioner correctly determined that the full value of the jointly owned property should have been included in the decedent's gross estate for estate tax purposes is to prevail, it must show (1) that, at least for the purposes of [§2040] of the Internal Revenue Code, profits and income which are produced by gift property subsequent to the making of the gift do not belong "originally" to the donee but are "received or acquired" by her from the donor, for the statute expressly exempts such part of the jointly held property as "originally" belonged to the surviving joint tenant and was not "received or acquired" by her from the decedent for less than an adequate and full consideration, or, in the alternative, (2) that the words "or produced by property which had been received or acquired" be read into the statute, so that the exception clause of [§2040] would read: "except such part thereof as may be shown to have originally belonged to such other person and never to have been received or acquired or *produced by property which was received or acquired* by the latter from the decedent for less than an adequate and full consideration in money or money's worth . . ." The cases relied on by the government fall short, we think, of establishing either of these postulates.

In Tyler v. United States, 281 U.S. 497, the Supreme Court, in sustaining [§2040] against attacks of unconstitutionality, held only that it was not arbitrary, capricious or violative of the due process clause of the Fifth Amendment to require that there be included in the gross estate of a decedent the total value of the property held by him and another as tenants by the entirety, the specific property having come to the tenancy as a gift from the decedent. United States v. Jacobs, 306 U.S. 363, 371-373; and Fernandez v. Wiener, 326 U.S. 340, likewise involve questions of constitutionality, the former holding that the statutory provision here involved was applicable and, when so applied, constitutional where the property held in joint tenancy had originally been received by the surviving joint tenant, *prior to the passage of the statute,* as a gift from the decedent, and the latter upholding the constitutionality of Section 811(e)(2) of the [1939] Code

(relating to the taxation of community property), which has since been repealed.* These cases, although perhaps persuasive of the proposition that a statute requiring inclusion in the gross estate of a decedent of all property held in joint tenancy by the decedent and any other person, irrespective of the source of the property so held, would not be unconstitutional, certainly do not justify us in saying that this statute as written, is to be interpreted as the government contends it should be in the instant case.

Hornor's Estate v. Commissioner, 3 Cir., 130 F.2d 649 and Stuart v. Hassett, D.C., 41 F. Supp. 905, also relied on by the government, are decisions which go no further than to apply the provisions of [§2040] to cases which fall clearly within its orbit. In the first of these cases, it was held that the entire value of property owned by the decedent and his wife as tenants by the entirety was taxable to the decedent's estate, his wife having contributed to the tenancy nothing other than property given her by the decedent, while in the *Stuart* case it was held that, where the decedent paid for property to which title was taken in his wife's name, and that property was subsequently conveyed by the wife to a straw who reconveyed to the decedent and his wife as joint tenants, the entire value of the property was taxable to the decedent's estate. And, finally, Estate of Howard v. Commissioner, 9 T.C. 1192, the only cited case which deals with the precise question presented by this appeal, held that, of the jointly owned property there involved, that portion which was shown to have been purchased out of dividends received by the wife on stock which the decedent had previously given her was within the exception set out in [§2040], the Tax Court thus rejecting the interpretation there urged by the Commissioner, which is, of course, the very interpretation now pressed by the government.

It seems clear that none of the cases cited contains any support for the novel proposition that income produced by gift property, after the gift has been completed, belongs to the donor and is property received or acquired from him by the donee; nor is there, in these cases, anything to impeach the conclusion of the trial court, or that of the Tax Court in the *Howard* case, that the income produced by property of any kind belongs to the person who owns the property at the time it produces such income and does not originate with a donor who has made a completed gift of that property prior to its production of the income. Similarly, they fail to sustain the contention that the statute should be interpreted as excepting from inclusion in the gross estate such part of the jointly held property "as may be shown to have originally belonged to such other person and never to have been received or acquired *or produced by property which was received or acquired* by the latter from the decedent for less than an adequate and full consideration in money or money's worth." . . .

Although it concedes that the case of Estate of Howard v. Commissioner, 9 T.C. 1192, supports the decision of the District Court insofar as it relates to dividends, rentals and interest, the government contends that the case "apparently" supports its position with respect to profits derived from the sale of property previously received by the surviving joint tenant as a gift from the decedent. This contention is founded on the court's statement that "If the proceeds from the sale of this stock had been deposited in the joint bank account, that would be another matter." Placing these words in context, however, it is obvious that all the Tax Court was saying was that if gift property is converted into another

* Section 811(e)(2) of the 1939 Code, in force from 1942 to 1948, required community property to be included in its entirety in the gross estate of the first spouse to die, except to the extent that it was shown to be attributable to the surviving spouse's earnings or separate property; but in any event, one half was includible because of the decedent's power of testamentary disposition. Supra page 1107. — ED.

form of property, which is then placed in joint tenancy, the converted property is not within the exception provided for in [§2040]; its statement can not logically be interpreted as meaning that "profits" or "gains," as distinguished from "proceeds" or "property received in exchange," do not fall within the scope of the exception. Moreover, no reason is suggested for holding that one form of income, i.e., "profit gained through a sale or conversion of capital assets," Eisner v. Macomber, 252 U.S. 189, 207, is outside the exception, whereas other forms of income, such as dividends, rentals and interest, fall within its terms. It follows that the government's contention that the full value of the property held in joint tenancy by decedent and his wife at the time of his death should have been included in decedent's gross estate must be rejected. . . .

The trial court's conclusion that certain certificates of shares having an aggregate value of $75,000, along with some farm equipment valued at $10,250, were owned by the decedent and his wife as tenants in common, rather than as joint tenants is also attacked. Six of the certificates were payable to "A. C. Harvey or Elizabeth Harvey"; three to "either A. C. or E. C. Harvey"; and the remaining four to "A. C. Harvey and/or E. C. Harvey." The government argues that in each instance, the quoted language satisfies the requirements of the Illinois statute which abolished the right of survivorship as between joint owners of personal property (excepting executors and trustees) and converted joint tenancies into tenancies in common in all cases except those in which there is a "will or other instrument in writing expressing an intention to create a joint tenancy in personal property with the right of survivorship." Ill. Rev. Stat. Ch. 76, Sec. 2. With respect to the farm equipment, it is the government's position that, since it was purchased with funds drawn from a joint bank account, it too was held in joint tenancy. The United States also relies on the fact that, on the tax return, the wife as executrix, listed the certificates and the farm equipment as jointly owned property, but this fact is of no avail to the government, for the form of ownership of property is not determined by the manner in which it is listed on a tax return but by reference to the state law applicable thereto. Greenwood v. Commissioner, 9 Cir., 134 F.2d 915. And, in view of the provisions of the applicable Illinois statute, it is evident that the District Court correctly held that the farm equipment, as to which there was no written instrument of any kind to satisfy the statutory requirement, was owned by the decedent and his wife as tenants in common. Thus, the only question is whether the language of the certificates can be said to express "an intention to create a joint tenancy in personal property with the right of survivorship."

That the Illinois courts do not regard the term "either . . . or" as sufficiently expressive of an intention to create a joint tenancy is clear from the decision in Lindner & Boyden Bank v. Wardrop, 370 Ill. 310, 18 N.E.2d 897, which involved a certificate of deposit which read, "William Wardrop or Bertha Nash has deposited in this bank seven hundred fifty and no/100 dollars payable to the order of either of them. . . ." The court, stating that "no question of survivorship arises since the certificate does not so provide," held this language insufficient to create a joint tenancy. The same result was reached where certificates were issued in the names of a husband and wife and made payable to either of them. Englebrecht v. Englebrecht, 323 Ill. 208, 153 N.E. 827. Illustrative of the marked reluctance of the Illinois courts to allow creation of a joint tenancy in personal property is the recent case, In re Wilson's Estate, 404 Ill. 207, 88 N.E.2d 662, 663, Note, 45 Ill. L. Rev. 285, in which the state Supreme Court held that no joint tenancy existed with respect to the contents of a safe deposit box, though the lease card for the box bore the words "as joint tenants with the right of survivorship and not as tenants in common" and the box itself contained a note written

by the husband stating that the money which was in the box was held in joint tenancy by his wife and himself. Thus, it seems clear that the District Court correctly determined that, under the law of Illinois, the certificates were held by the decedent and his wife as tenants in common and not as joint tenants.

The government has suggested that, even though it is held that the decedent and his wife owned the certificates and the farm equipment as tenants in common, still it was incumbent on the wife to show the amount contributed by her in the acquisition of this property and that only such amount may properly be deducted from the decedent's gross estate; consequently, it cites as error the District Court's allowance of the deduction of one half the value of the aforementioned property. The fallacy in this argument is that the provisions of [§2040] are not applicable to property held in tenancy in common. See Treasury Regs. [§20.2040-1(b)]. Therefore, since it is the law of Illinois, that, absent evidence to the contrary, tenants in common take equal shares, Keuper v. Mette's Unknown Heir, 239 Ill. 586, 592, 88 N.E. 218, the allowance of the deduction of one-half the value of the property so held was entirely proper.

NOTE

1. *Implications of Harvey case.* Is the result in the *Harvey* case in harmony with the purpose of the statute? Consider these problems of applying the *Harvey* case, assuming in each case that H gave W stock worth $50,000:

(a) W receives a dividend of $20,000 (no substantial profits having been realized by the corporation after the gift to W) and uses this sum to purchase jointly held property.

(b) On selling the stock for $75,000, W deposits the entire amount in her bank account. Thereafter she uses $25,000 to buy property in joint tenancy.

(c) When the stock is worth $75,000, W uses it to purchase property in their joint name. Is this to be treated differently from the sale of the stock for $75,000, followed by a purchase of the jointly held property for cash?

See also First Nat. Bank of Kansas City v. United States, 223 F. Supp. 963 (W.D. Mo. 1963) (stock given to wife by husband in 1936 and sold by her in 1948; held, jointly held assets acquired with proceeds of sale not includible in estate of husband, who predeceased wife); Tuck v. United States, 282 F.2d 405 (9th Cir. 1960) (decedent gave shares of stock to wife in 1919, which she placed in joint tenancy in 1922 together with stock dividends received in 1921; held, decedent's estate includes both original and dividend shares where latter represented pre-1919 earnings); McGrew's Estate v. Commissioner, 135 F.2d 158 (6th Cir. 1943) (held, on the facts, that funds used by wife to open joint bank account were received from decedent as a gift rather than to repay prior advances by her to him); Bremer v. Luff, 7 F. Supp. 148 (N.D.N.Y. 1933) (wife's liability on mortgage treated as consideration attributable to her).

In United States v. Neel, summarized supra page 1081, joint bank accounts were treated in effect as partnership accounts, so that only the decedent's pro rata interest was includible in his gross estate; for a similar case, see Berkowitz v. Commissioner, 108 F.2d 319 (3d Cir. 1939); but cf. Bushman v. United States, 8 F. Supp. 694 (Ct. Cl. 1934), cert. denied, 295 U.S. 756 (1935).

For the possibility that a completed inter vivos gift of property may be made even though, as a matter of convenience, it is held in joint ownership, see Doyle's Estate v. Commissioner, 32 T.C. 1209 (1959) (on the facts, completed gift not established).

2. *Jointly held property attributable to surviving spouse.* If the jointly held property is attributable in full to the surviving spouse, §2040 does not require its inclusion in the decedent's gross estate. Moreover, it is widely assumed that nothing is includible under §2033 in such a case even though the decedent until his death could have made an effective conveyance of one half of the property. (A similar assumption is customary regarding non-inclusion under §2041, relating to powers of appointment.) Would an amendment of the statute to take account of the decedent's economic control be appropriate? Note that the 1942-1948 treatment of community property (supra p. 1107) required one

half to be included in the estate of the first spouse to die, in recognition of his testamentary power over this amount, even though the surviving spouse was the sole economic source of the community property.

3. *Presumptions.* For the effect of local law presumptions regarding the amount of consideration contributed by the parties to a joint tenancy, see Robinson v. Commissioner, 63 F.2d 652 (6th Cir. 1933), cert. denied, 289 U.S. 758 (state presumption does not override §2040's requirement of proof of survivor's contribution); City Bank Farmers Trust Co. v. Commissioner, 41 B.T.A. 1 (1940) (accord, even though evidence unobtainable because H and W perished in common disaster). Note the last sentence of the *Harvey* opinion, regarding the force of a local presumption that, if no intent to the contrary is shown, a conveyance to A and B creates a tenancy in common rather than a joint tenancy; see also Dennis v. Commissioner, 26 B.T.A. 1120 (1932) (state law controls).

The final clause of §2040 provides a federal rule for determining what fraction of jointly held property is to be included in the gross estate of the first tenant to die, if the tenants received the property by gift or bequest and their fractional interests were "not otherwise specified or fixed by law."

4. *Transfers of jointly held property in contemplation of death.* For the troublesome problems that arise if jointly held property is transferred in contemplation of death, see page 1143 infra.

5. *Gift tax on creation of joint tenancy or tenancy by entirety.* Section 2515 provides that the creation of a tenancy by the entirety (specially defined by §2515(d) to include a joint tenancy with right of survivorship) in real property between husband and wife shall not be treated as a transfer for federal gift tax purposes, regardless of the proportion in which the consideration for the property is paid, unless the donor makes an election to the contrary. The provision was enacted in 1954 because, according to the Senate Report on the 1954 Code (p. 128), many married couples who buy a home "have no intention of making a gift at the time of the creation of the tenancy or any knowledge that they are considered as having done so." Section 2515 applies only to real property, but it includes investment and business property as well as residences. Under §2515, a taxable gift will occur if the property is sold, unless the proceeds are distributed in proportion to each spouse's contribution to the property (including the original purchase price and payments for improvements or in reduction of a mortgage).

If §2515 is inapplicable (because the donor elected to have the transfer treated as a gift, the tenancy consists of personal property, or the tenancy is not between husband and wife), the gift tax results on the creation of a joint tenancy or tenancy by the entirety depend on whether the donee receives the right to sever the tenancy by a separate conveyance (as in the typical joint tenancy) or can make an effective conveyance under local law only if the other tenant joins in the conveyance (as in the typical tenancy by the entirety).

The creation of a joint tenancy between A and B constitutes a gift of one half of the value of the property by A (assuming he furnishes the entire consideration) to B, unless A retains the right to retake the property without B's consent (as in the case of the ordinary joint bank account or U.S. savings bond payable to A or B or the survivor). Regs. §25.2511-1(h)(4) and (5); but see Silverman v. McGinnes, 259 F.2d 731 (3d Cir. 1958) (effective inter vivos gift of U.S. Series E bonds, although registered in joint names). The creation of a tenancy by the entirety, however, is a gift of the actuarial value of B's interest, i.e., the right to receive the property if she survives A, plus the right to receive one half the income of the property in the interim. (In a few states, the wife may not be entitled to any of the income, in which event the gift consists of the survivorship interest alone.) Regs. §25.2515-2; Commissioner v. Hart, 106 F.2d 269 (3d Cir. 1939). For the possibility of a gift tax on a termination of a tenancy by the entirety, see Regs. §25.2515-4.

Is the gift tax exclusion allowable on the creation of a joint tenancy or tenancy by the entirety?

For the effect of the marital deduction in this area, see page 1286 infra.

6. *Gift tax credit.* If a gift tax is paid on the creation of a joint tenancy, and the property is included in the estate of the donor under §2040 because he was its economic

source, his estate will be entitled to a gift tax credit under §2012, although the amount credited will not necessarily be the full amount paid (infra p. 1330). If the donee dies first, however, so that the property reverts to the donor, it is possible that a gift tax credit will not be allowed to his estate because §2012 applies only if an "amount in respect of [the] gift is required to be included in the value of the gross estate of the decedent"; it is arguable that this does not apply to property owned by the donor, rather than by the donee, on the donor's death.

7. *References.* Rudick, Federal Tax Problems Relating to Property Owned in Joint Tenancy and Tenancy by the Entirety, 4 Tax L. Rev. 3 (1948); Rosenberg, Gift Taxes on Estates by the Entireties, 24 Taxes 965 (1946); Comment, Problems of Estate and Gift Taxation of Joint Ownership Interests, 10 U.C.L.A. L. Rev. 1205 (1963).

CHAPTER 13

The Gross Estate: Transfers During Life

SECTION A. GIFTS IN CONTEMPLATION OF DEATH: §2035

Since the inception of the federal estate tax in 1916, property transferred by the decedent in contemplation of death has been swept back into his gross estate. From 1916 to 1950, the statute also contained a rebuttable presumption that a transfer by the decedent "of a material part of his property in the nature of a final disposition or distribution thereof," if made within 2 years of death, was a transfer in contemplation of death. The strength of the presumption was problematical; because the Commissioner's deficiencies are already prima facie correct, the presumption was likened to "a handkerchief thrown over something covered by a blanket also." Paul, Federal Estate and Gift Taxation 92 (1946 Supp.).

In 1926, when the 1924 federal gift tax was repealed (supra p. 1006), an irrebuttable presumption of transfer in contemplation of death was added to the estate tax law, applicable to gifts within 2 years of death, to the extent in excess of $5000 per donee. Three days later, the Supreme Court (Holmes, Brandeis, and Stone dissenting) held that a similar Wisconsin statute (as to gifts within six years of death) was in violation of the Fourteenth Amendment. Schlesinger v. Wisconsin, 270 U.S. 230 (1926). Mr. Justice McReynolds, writing for the Court, could find "no adequate basis" for distinguishing gifts made within the statutory period from those made outside it; as for the anti-evasion function of the presumption, he found it to be an unconstitutional attempt to subject " 'A' . . . to an exactment forbidden by the Constitution if this seems necessary in order to enable the State readily to collect lawful charges against 'B.' " In 1932, the Court held that the federal presumption of 1926 was forbidden by the Fifth Amendment over a strong dissent by Stone and Brandeis (Cardozo not participating), which analyzed in detail the government's factual and legal arguments in support of the presumption. Heiner v. Donnan, 285 U.S. 312 (1932). Following this decision, the irrebuttable presumption was repealed. As to the present vitality of Heiner v. Donnan, see 1 Paul, Federal Estate and Gift Taxation §6.26 (1942); Lowndes, Current Constitutional Problems in Federal Taxation, 4 Vand. L. Rev. 469, 488-490 (1951).

Throughout the period 1916-1950, transfers made outside the presumptive period could be included in the gross estate if, without recourse to the presumption, they were made in contemplation of death. In 1950, however, the final clause of what is now §2035(b) was enacted, providing that gifts made more than 3 years before death may not be included in the gross estate as gifts in contemplation of death. At the same time, the language of the rebuttable presumption was given in its present form, and the period to which it applies was extended from 2 to 3 years. The Senate Finance Committee (S. Rept. No. 2375, 81st Cong., 2d Sess., 1950-2 C.B. 524-5) explained the change as follows:

> While the inclusion in the gross estate of transfers in contemplation of death has long been regarded as necessary to prevent avoidance of the estate tax, the administration of this feature of the estate tax law has always proved difficult. Principally this is due

to the fact that contemplation of death deals with the intent of the transferor. Intent is extremely difficult to establish in any case and becomes increasingly so with the passage of time. Undoubtedly many gifts in contemplation of death have escaped the estate tax because of the difficulty which the Government encounters in reconstructing the motives of the deceased. On the other hand, complaints have been received that the Bureau of Internal Revenue has in some cases asserted that gifts made many years before death were in contemplation of death without having much basis for the assertion. As a result executors of estates are confronted with an unpleasant choice between compromising the asserted tax liability or engaging in expensive and difficult litigation. At the present time this problem hangs over any person who makes a gift, even though he expects to live for many years, unless he can prepare evidence demonstrating that the gift was made primarily for nontax reasons.

Section [2035(b)] removes from the scope of the contemplation of death clause all transfers made more than 3 years prior to the date of death. On the other hand, the burden of showing that the transfer was not in contemplation of death will be borne by the estate in all cases where the transfer was made within a period of 3 years ending with the date of death. This will strengthen the position of the Government in cases where the transfer occurred between 2 and 3 years prior to the date of death.

UNITED STATES v. WELLS

283 U.S. 102 (1931)

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

[The Court's statement of facts is omitted.]

The Court of Claims did not find, in terms, that the transfers in question were not made in contemplation of death, but it is evident that the court considered that its findings of fact amounted to that in substance. . . . The court said [39 F.2d at 1011]:

> The plaintiffs have not only overcome the [rebuttable 2-year] presumption . . . that the transfers were made in contemplation of death but have definitely established the fact that the immediate and moving cause of the transfers was the carrying out of a policy long followed by decedent in dealing with his children of making liberal gifts to them during his lifetime. He had consistently followed that policy for nearly thirty years and the three transfers in question were a continuation and final consummation of such policy. In the last transfer such amounts were given to his children as would even them up one with another, in the gifts and advancements made to them.
>
> That this was the motive which actuated the decedent in making these transfers seems unquestioned. He repeatedly, in letters to his children and in statements to business associates at about the time the transfers were made, gave this as his reason for such transfers.
>
> After the final transfer in which the advancements and gifts to the children were evened up in January, 1921, the decedent still possessed property of the value of nearly $900,000, from which he drew an annual income of approximately $50,000. At the time the transfers were made, decedent had no reason to believe otherwise than [that], aside from his asthma, he was, for a man of his age, in ordinary health. While he had gone through a most serious and painful illness, he had, as he believed, made an almost complete recovery. He was assured of this fact by his physician, an eminent specialist, in whom he had great confidence. The repeated statements made to him by close friends and associates, his daily activities in matters connected with his business affairs, his letters to his children assuring them of his renewed health, show that he fully believed the assurances given him by his physician that he was cured and had nothing to fear on account of his former illness.
>
> The presumption created by the statute that the transfers in question were made in contemplation of death can not stand against ascertained and proven facts showing the contrary to be true. The best evidence of the state of the decedent's health at the time the transfers were made is the statement of his doctor. The best evidence of the decedent's state of mind at that time and the reasons actuating him in making the transfers

are the statements and expressions of the decedent himself, supported as such statements are by all the circumstances concerning the transfers.

The Government contests the decision of the Court of Claims upon the ground that the conclusion was reached by an erroneous construction of the words "in contemplation of death" as used in the statute. The court held that " 'contemplation of death' does not mean that general knowledge of all men that they must die, but that there must be a present apprehension, from some existing bodily or mental condition or impending peril, creating a reasonable fear that death is near at hand, and that such reasonable fear or apprehension must be the direct or animating cause, and the only cause of the transfer." The Government insists that this definition is too narrow; that transfers in contemplation of death are not limited to those induced by a condition causing expectation of death in the near future; that the character of such gifts is determined by the state of mind of the donor at the time they are made, and that the statutory presumption may be overcome only by proof that the decedent's purpose in making the gift was to attain some object desirable to him during his life, as distinguished from the distribution of his estate as at death.

The phrase "in contemplation of death," previously found in state statutes, was first used by the Congress in the Revenue Act of 1916, imposing an estate tax.* It was coupled with a clause creating a statutory presumption in case of gifts within two years before death. The provision was continued in the Revenue Act of 1918, which governs the present case, and in later legislation. While the interpretation of the phrase has not been uniform, there has been agreement upon certain fundamental considerations. It is recognized that the reference is not to the general expectation of death which all entertain. It must be a particular concern, giving rise to a definite motive. The provision is not confined to gifts causa mortis, which are made in anticipation of impending death, are revocable, and are defeated if the donor survives the apprehended peril. Basket v. Hassell, 107 U.S. 602, 609, 610. The statutory description embraces gifts inter vivos, despite the fact that they are fully executed, are irrevocable and indefeasible. The quality which brings the transfer within the statute is indicated by the context and manifest purpose. Transfers in contemplation of death are included within the same category, for the purpose of taxation, with transfers intended to take effect at or after the death of the transferor. The dominant purpose is to reach substitutes for testamentary dispositions and thus to prevent the evasion of the estate tax. Nichols v. Coolidge, 274 U.S. 531, 542; Milliken v. United States, 283 U.S. 15. As the transfer may otherwise have all the indicia of a valid gift inter vivos, the differentiating factor must be found in the transferor's motive. Death must be "contemplated," that is, the motive which induces the transfer must be of the sort which leads to testamentary disposition. As a condition of body or mind that naturally gives rise to the feeling that death is near, that the donor is about to reach the moment of inevitable surrender of ownership, is most likely to prompt such a disposition to those who are deemed to be the proper objects of his bounty, the evidence of the existence or non-existence of such a condition at the time of the gift is obviously of great importance in determining whether it is made in contemplation of death. The natural and reasonable inference which may be drawn from the fact that but a short period

* The phrase first appeared in the New York Inheritance Tax Law of 1891 (Laws, 1891, c. 215, §1), and was early held to apply only to gifts causa mortis. Matter of Seaman, 147 N.Y. 69, 41 N.E. 401 (1895). The phrase soon found its way into the statutes of other states; by the time it appeared in the Revenue Act of 1916, it was generally held by state courts (including New York, in effect if not explicitly) not to be restricted to gifts causa mortis. Annotations, 18 L.R.A. (N.S.) 458 (1909); 46 id. 790 (1913); 7 A.L.R. 1028, 1030 (1920). — Ed.

intervenes between the transfer and death, is recognized by the statutory provision creating a presumption in the case of gifts within two years prior to death. But this presumption, by the statute before us, is expressly stated to be a rebuttable one, and the mere fact that death ensues even shortly after the gift does not determine absolutely that it is in contemplation of death. The question, necessarily, is as to the state of mind of the donor.

As the test, despite varying circumstances, is always to be found in motive, it cannot be said that the determinative motive is lacking merely because of the absence of a consciousness that death is imminent. It is contemplation of death, not necessarily contemplation of imminent death, to which the statute refers. It is conceivable that the idea of death may possess the mind so as to furnish a controlling motive for the disposition of property, although death is not thought to be close at hand. Old age may give premonitions and promptings independent of mortal disease. Yet age in itself cannot be regarded as furnishing a decisive test, for sound health and purposes associated with life, rather than with death, may motivate the transfer. The words "in contemplation of death" mean that the thought of death is the impelling cause of the transfer, and while the belief in the imminence of death may afford convincing evidence, the statute is not to be limited, and its purpose thwarted, by a rule of construction which in place of contemplation of death makes the final criterion to be an apprehension that death is "near at hand."

If it is the thought of death, as a controlling motive prompting the disposition of property, that affords the test, it follows that the statute does not embrace gifts inter vivos which spring from a different motive. Such transfers were made the subject of a distinct gift tax, since repealed. As illustrating transfers found to be related to purposes associated with life, rather than with the distribution of property in anticipation of death, the Government mentions transfers made "for the purpose of relieving the donor of the cares of management or in order that his children may experience the responsibilities of business under his guidance and supervision." The illustrations are useful but not exhaustive. The purposes which may be served by gifts are of great variety. It is common knowledge that a frequent inducement is, not only the desire to be relieved of responsibilities, but to have children, or others who may be the appropriate objects of the donor's bounty, independently established with competencies of their own, without being compelled to await the death of the donor and without particular consideration of that event. There may be the desire to recognize special needs or exigencies or to discharge moral obligations. The gratification of such desires may be a more compelling motive than any thought of death.

It is apparent that there can be no precise delimitation of the transactions embraced within the conception of transfers in "contemplation of death," as there can be none in relation to fraud, undue influence, due process of law, or other familiar legal concepts which are applicable to many varying circumstances. There is no escape from the necessity of carefully scrutinizing the circumstances of each case to detect the dominant motive of the donor in the light of his bodily and mental condition, and thus give effect to the manifest purpose of the statute.

We think that the Government is right in its criticism of the narrowness of the rule laid down by the Court of Claims, in requiring that there be a condition "creating a reasonable fear that death is *near at hand,*" and that *"such* reasonable fear or apprehension" must be "the only cause of the transfer." It is sufficient if contemplation of death be the inducing cause of the transfer whether or not death is believed to be near. But it does not appear that the decision of the court rests upon the limitation thus expressed. The court did not rely merely

upon the fact that at the time of the transfers decedent considered that he had recovered from his former illness and believed the assurances given him by his physician that he need have no fear of its recurrence or any "anxiety whatever about his state of health." That fact was manifestly important, but, in addition to that, the court held that "the immediate and moving cause of the transfers was the carrying out of a policy, long followed by decedent in dealing with his children, of making liberal gifts to them during his lifetime." The court regarded the transfers in question as "a continuation and final consummation of such policy," saying "that this was the motive which actuated the decedent in making these transfers seem unquestioned." In the view of the court as thus explicitly stated, not only was there no fear at the time of the transfers that death was near at hand, but the motive for the transfers brought them within the category of those which, as described by the Government, are intended by the donor "to accomplish some purpose desirable to him if he continues to live." In the presence of such a motive, appropriately found, and of the underlying facts which have been expressly found, there would be no ground for a reversal of the judgment merely because of an inaccuracy in the general statement as to the meaning of the statutory phrase. . . .

Judgment affirmed.

MR. JUSTICE ROBERTS took no part in the consideration or decision of this case.

ESTATE OF OLIVER JOHNSON v. COMMISSIONER

10 T.C. 680 (1948)

The Commissioner determined a deficiency of $44,765.91 in estate tax liability. The value of the gross estate was determined in part by including the value of property transferred by the decedent during his lifetime. The sole issue for decision is whether such property was transferred in contemplation of death. . . .

Findings of Fact

The parties have filed a stipulation of facts which is incorporated herein by reference.

The decedent, Oliver Johnson, died March 8, 1943, at the age of 94 years, a resident of Long Beach, California. He was survived by 5 children: C. Elmer Johnson, Alla J. Ross, Bertha J. Landreth, T. Leman Johnson, and Bula J. Simms. The children ranged between the ages of 50 and 68 at the date of decedent's death. The executrix of the estate is Alla J. Ross. The estate tax return was filed with the collector of internal revenue for the sixth district of California.

The decedent was born in Iowa on November 4, 1848. He was one of nine children, four of whom were alive in 1939. In 1878 he became a resident of Belleville, Kansas. In 1905 he moved to Courtland, Kansas, where he remained until 1918. During decedent's residence in Kansas he was primarily a farmer. He acquired 9 tracts of farm lands between 1883 and 1916, containing a total of 1,487½ acres in Republic County, Kansas. Two of these tracts were improved with a house and barns; 2 others with a house each. Sometime prior to 1918 the decedent placed the active farming of these properties with tenants. He also made loans on notes and mortgages. For a short time before the first World War he owned a controlling interest in a small bank in Courtland, Kansas.

In 1918 the decedent and his wife decided to leave Kansas in order to escape the cold weather and move to California, where they had wanted to live and where they could be out of doors more often. Pursuant to their decision, they

sold all of their household effects and set out for California by way of Wenatchee, Washington, where one or more of their children lived. They spent the winter in Washington and moved to Long Beach, California, in 1919.

The decedent arrived in Long Beach, California, shortly prior to his seventy-first birthday. He considered himself a retired farmer, but he retained an active interest in his farm properties. He returned to Kansas virtually every year during four or five months in the summer and fall of each year until 1939. During these months he inspected his farms, transacted business, and visited friends. In 1920 the decedent bought a house in Long Beach for himself and his wife. He acquired one other house in 1921 and in 1925 purchased a two-story office building in Corona, California, in which his daughter Bula and her husband operated a drug store.

In 1927 the decedent's wife died. The decedent purchased crypts for himself and his wife in the Sunnyside Mausoleum of Long Beach. The decedent then lived with his son Elmer for approximately one year. Thereafter he lived alone in rented rooms during the winters until 1937. In that year he purchased the Oliver Apartments in Long Beach, where he kept an apartment for himself until he moved to the home of his daughter Alla in August of 1940.

Prior to 1932 the decedent made a number of loans, usually at 6 per cent interest and secured by trust deeds and mortgages on real estate in California. These loans were made through the Golden State Bond & Mortgage Co. In 1932 the Golden State Bond & Mortgage Co. became financially embarrassed. Between 1932 and 1934 the decedent acquired the outright ownership of 21 or more small rental properties because of defaults on the loans he had made. In each case the decedent paid something for the equity and received deeds from the owners. In each case the title to these properties was encumbered by local tax and other municipal liens.

Between 1934 and 1939 the decedent owned a total of 28 or more properties in Southern California, some of which were occupied by more than one tenant. Rent collections, repairs, and clearing of the titles required the work of 2 men. The decedent, who was 85 years of age in 1933, worked from 9 in the morning until 4:30 or 5 o'clock at night, 4 and 5 days a week. In 1933 the decedent hired his son Elmer as a full time employee at a salary of $350 a month. This salary was raised to $400 a month for the first 6 months in 1939. Elmer furnished transportation, acted as bookkeeper, and filled out the decedent's tax returns for the years 1930 to 1939 inclusive. The decedent had not owned an automobile since 1918 and had never filled out his own tax return. The decedent kept some accounts in a pocket notebook and retained his bank statements. When the decedent returned to Kansas each year the management of the Long Beach properties was carried on by Elmer. Bula J. Simms and her husband collected the rents on the Corona property. Elmer and Bula were authorized to and did make deposits on behalf of the decedent in bank accounts he maintained in Long Beach and Corona, respectively.

Prior to 1939, the decedent had stated several times that he did not like small rental properties. He had so stated when a real estate broker attempted to interest him in such properties. In 1933 he told his daughter Bula that he was going to have to take active management of such properties, due to the failure of the mortgage company. He stated that he never liked the management and intended to give the properties to his children as soon as he could clear up the titles. He told the same thing to his son Leman in 1935, saying that when the titles were clear he was going to make a division of those properties for his children so that he could see them enjoy the properties while he was still alive. He was desirous of making an equal division and one that would satisfy the children.

He had told Elmer of his intentions about the property division on several occasions.

The last encumbrance was cleared away in late 1938. A few days prior to March 3, 1939, the decedent told his daughter Bertha and her husband, who were then visiting in Long Beach, that he had a surprise which he thought would make all the children happy. The decedent had itemized gifts of his real property for all the children, saying that he had always intended making the gifts but had never before had them in the proper shape, free and clear of encumbrances. He stated that he wanted the children to look over these properties in order to make a division that would satisfy all of them. The three of them then drove to Corona to tell his daughter Bula.

The next morning the decedent stated that he wanted the children to know why he was making the gifts of his real property. He said that he did not want them to think that he was not going to live very long because he expected to live a long time. He stated that he did not think he wanted to go back to Kansas again and that he did not want to be bothered with the rental properties. He said that he would keep his notes and mortgages and would therefore never have to go to his children for care. Thereafter the party returned to Long Beach and made a tour of the Long Beach properties with his son Elmer. A short time later an attorney was given a description of the properties and told to draw up the deeds, which the decedent signed on March 3, 1939. Two of the decedent's children were not present in Long Beach when the gifts were made.

The gifts consisted of all the decedent's real properties. At the date of the gifts the decedent owned 9 Kansas farms, and each of the chidren received at least one tract. The Corona property was given in equal, undivided shares to Bertha and Bula. The latter took title jointly with her husband. The remaining 21 properties which the decedent had acquired between 1932 and 1934, in addition to 6 properties which he had purchased outright, all located in Long Beach, were divided among all of the children. There was an oral condition to the gift. Extensive repairs and alterations had been undertaken on the Corona property. The parties orally agreed that all the rentals from the Long Beach properties would be applied on the cost of the Corona repairs until July 1, 1939. This was done. Thereafter the decedent took no part in the management of any of the real property.

The decedent had valued all his real property at $175,000 and divided it so that each child received property valued at $35,000. Three children requested that title be given to them jointly with their respective spouses. As a result, the decedent claimed exclusions of $32,000 and an exemption of $40,000 on his gift tax return filed on January 30, 1940. The tax paid amounted to $7,582.50. As the result of an audit by the Bureau of Internal Revenue the total valuation of the gifts was increased to $203,900, and an additional tax of $3,684.75 was later paid. The agreed value of the property at the date of decedent's death in 1943 was $255,950.

At the date of the gift the decedent retained notes and obligations executed by 17 parties, ranging in amounts between $49.10 and $21,000, which had an aggregate value of $43,255.21. All of these obligations paid 6 per cent interest with the exception of one or two of the smaller ones. The decedent also retained $6,178.64 in cash, of which $3,806.62 was in a savings bank in Los Angeles and the balance was in banks in Corona and Long Beach. The total property retained had an actual value of $49,433.53 at the date of the gift.

The decedent's age at the date of the gift on March 3, 1939, was 90 years and 4 months. He lived moderately and inexpensively. He lived in single rooms and ate at small restaurants. He bought ready-made clothes, and liked bright-

colored neckties. He had no expensive pastime or hobby. He had stated that he knew how to make money, but had never learned to spend it. In April of 1939 his daughter Alla moved into the Oliver Apartments which the decedent had given her on March 3, 1939. The decedent, who had lived there since 1937, began taking his meals from her. He paid her $25 a month for his room and $75 for meals and transportation. This latter amount was raised to $100 a month in 1941. The expenses of the decedent were not in excess of approximately $150 a month. The decedent reported in his income tax returns the following net income.

1936	$4,894.29	1940	$2,337.90
1937	8,869.02	1941	2,047.48
1938	5,458.06	1942	1,664.79
1939	5,718.13		

The decedent was independent of his family. He did not like to have his affairs handled by lawyers. He pursued his own hobbies. He liked to walk, ran his own errands, and regularly covered on foot the 9 blocks from his room to church alone. On one occasion in 1940 he walked some 70 blocks, accompanied by his daughter, in order to go to the bank, visit friends, and have dinner in downtown Long Beach. He walked as fast as anyone. He was erect and had a young man's carriage.

The decedent also liked to travel. Each year from 1928 to 1939 he traveled alone to Kansas for the purpose of overseeing his farms, and to many other states in order to visit friends and relatives. During these visits he was in the habit of corresponding with various members of his family. Numerous letters of decedent were introduced in evidence and are incorporated herein by reference. Their tone is cheerful, alert, and businesslike. The following is a typical example:

Courtland, Kansas, August 6, 1938

Mr. & Mrs. Grant and Bula
Corona, Calif.

Your good letter came to hand this day and I am pleased to hear the news. I will try to answer this time. Yes, I have been busy and over the river part of the time. But I will be done next week. The rains kept people out of the fields so much and we couldn't help that, see? All done but Orin Reid and Dan Rickle and he will finish next week. I hope he will finish my 60 acres. He will put my share with his and sell it for oatmeal and get a better price in that way. The wheat was not worth much this year, the corn over there is sure fine, plenty roasting now. But I fear corn will be cheap, only 40 cts. now. I sold the old corn for that price except one load I sold part at 50 cts. I am pleased that you went to Church and glad that Brother Gordon can go to Church. I am pleased with the tone of your letter, so much news to hear. I would be pleased to hear often, then I could answer often. Try it once.

As ever,
Oliver Johnson

Cousin Till Warner is very sick, had two strokes, No hope for her.

O.J.

The decedent liked to call on his children unexpectedly and some of his visits were as early as 7 o'clock in the morning. He occasionally took the bus to Corona, California, to visit his daughter Bula. In the fall of 1939 the decedent made a 2-day trip by automobile to Boulder Dam and Death Valley, a distance of 800 miles, with members of his family. In 1940 the decedent returned to Long Beach with a son-in-law after a visit in Washington. On one occasion the party motored approximately 700 miles in one day and spent the next 2 days walking

through the San Francisco Fair before they returned to Long Beach. On the occasion of the 700-mile drive decedent sat in the back seat and urged his son-in-law to drive faster. The decedent suffered no effects from these trips.

The decedent was proud of his vigor and physical appearance. He weighed approximately 145 pounds. At one time in 1938, in order to demonstrate his agility, he jumped into the air and clicked his heels together 2 or 3 times before descending to the floor. In getting up from a chair at all times pertinent hereto he would stand up straight without touching the arms of the chair. He regarded himself as younger than other old men not yet his age and would comment with ridicule upon their elderly appearance. He frequently stated that he expected to live to be a hundred years old. He appeared 12 to 15 years younger than he actually was and regarded himself as a younger man. He had a full head of hair, which was iron gray. He was cheerful by nature and kept himself busy. The decedent was mentally alert and knew his business affairs.

He was active in church affairs. He was a member of the Church of Christ, which he attended regularly three times a week. In addition to visiting, walking, and church-going, he pursued the hobbies of horseshoe pitching and woodworking. He had an expert's skill in horseshoe pitching, making a large percentage of ringers. The woodworking was usually done in the decedent's rooms. He constructed such items as cupboards and footstools.

On or about June 5, 1939, the decedent wrote, dated, and executed in his own hand his last will:

Long Beach, California, June 5th, 1939.

I, Oliver Johnson, a widower, hereby made [sic] my last will. I revoke all wills by me heretofore mad [sic]. I give all my property both real and personaly [sic], all bonds, stocks, and mortgages of which I die possessed to my five children named. C. Elmer Johnson, Alla J. Ross, Bertha J. Landreth, Leman Johnson, and Bula J. Simms. I appoint my daughter, Alla J. Ross, as Executrix of this will without bond, without help of lawyer or attorney and without order of court or judge.

It is my will that the above named, who are all my own children [sic] come together by themselves, after my death and divide it eagrable [sic] between them. Each child must settle his account with the estate so that it will be equal. I declare this is entirely written [sic] dated and signed by own hand.

In 1934 the decedent had a mild case of pneumonia, for which a doctor's services were required. The services of a nurse were not required. Between 1927 and 1939 the decedent occasionally visited doctors for mild complaints in the nature of colds, stomach aches, and light-headedness. The decedent did not use glasses and did not use a hearing aid, although his hearing was impaired. In 1938 or 1939 the decedent visited Dr. Bradford, a chiropractor, complaining of a stomach ache and light-headedness. The decedent told Dr. Bradford that he had been to a doctor who told him that he had high blood pressure. The chiropractor found a constriction around the decedent's stomach and liver which he attributed to dietary habits. After 12 to 15 treatments for a month or 6 weeks, the condition was corrected. The chiropractor had the opinion that nothing was organically wrong with the decedent. He found the patient to be remarkably preserved, mentally alert, and very spry.

On four occasions, August 23 and September 23, in 1940, and January 22 and 26 of 1941, the decedent was visited by Dr. Hoover, a medical practitioner, of Long Beach. On each of these occasions the decedent complained of pains in the abdomen. The doctor was of the opinion that the pains were the result of poor circulation, which in turn was traceable to auricular fibrillation. Auricular fibrillation is a condition which is caused by a deterioration or aging of the heart and is manifest through an irregular beating of the auricles of the heart. The

damage to the heart develops gradually over a long period of time, but the noticeable irregularity appears without warning. The irregularity has the effect of impairing the efficiency of the circulation. By administering digitalis the heart action is slowed and the heart operates more efficiently. On at least three of the doctor's visits, digitalis was prescribed.

On January 20, 1941, the decedent gave one of his daughters a general power of attorney. The decedent's health notably failed in the latter part of 1942 and the early part of 1943. His daughter Alla, with whom the decedent lived, became ill. She could not give the care that the decedent needed and therefore the decedent was moved to the Los Alamitos Sanatorium 2 months before he died. The immediate cause of the decedent's death on March 8, 1943, was acute congestive heart failure of one day's duration and bronchopneumonia of 10 days' duration. Senility was listed as an "other condition."

Between 1900 and 1916 the decedent gave each of his children a gift which he evaluated at $2,400 to $2,500. Elmer received a wagon and team and a half interest in a hardware store where he worked. An indebtedness of Leman was canceled in 1913. Bula received a house and lot when she was married. After 1929, pursuant to his deceased wife's request, the decedent gave each of his children a one-fifth share in a note executed by Landreth Brothers of Wenatchee, Washington. The principal of the note had been advanced after 1918 or 1919. The principal and accrued interest thereon amounted to approximately $100,000. Apparently, since the date of the gift $10,000 to $12,000 has been realized on each one-fifth share.

At other times the decedent gave pianos to two of the children and equivalent gifts to the other three. He gave footstools to each child. He had also given Chinese coats to the daughters and suits to the sons.

The decedent's dominant motive in making the gifts in question was to rid himself of the active management of the property transferred. The transfers were not made in contemplation of death.

Opinion

KERN, Judge.

The sole question is whether the value of the transfers of March 3, 1939, should be included in the gross estate of the decedent [as gifts in contemplation of death].

The ultimate question to be decided in this case, as in others arising under the quoted statute, is whether the dominant or impelling motive of decedent in making these transfers was associated with death and was prompted by the thought of death.

This question is a subjective one. It concerns the motives and mental processes of a particular human being, in this case one Oliver Johnson, who made the transfers in question more than 10 years before the hearings were held in this proceeding and who died more than 4 years before those hearings.

Among the circumstances to be considered and weighed in determining what was the dominant motive of the decedent in making inter vivos transfers of his property, are the following: (a) The age of the decedent at the time the transfers were made; (b) the decedent's health, as he knew it, at or before the time of the transfers; (c) the interval between the transfers and the decedent's death; (d) the amount of the property transferred in proportion to the amount of property retained; (e) the nature and disposition of the decedent, e.g., whether cheerful or gloomy, sanguine or morbid, optimistic or pessimistic; (f) the existence of a general testamentary scheme of which the transfers were a part; (g) the relationship

of the donee or donees to the decedent, i.e., whether they were the natural objects of his bounty; (h) the existence of a long established gift-making policy on the part of decedent; (i) the existence of a desire on the part of the decedent to escape the burden of managing property by transferring the property to others; (j) the existence of a desire on the part of the decedent to vicariously enjoy the enjoyment by the donees of the property transferred; and (k) the existence of the desire by the decedent of avoiding estate taxes by means of making inter vivos transfers of property. This is not a comprehensive list of the circumstances pertinent to the problem of what transfers are made in contemplation of death, but it includes most of the circumstances and considerations pertinent to the instant case.

Of these circumstances, some are favorable to respondent's contentions that the transfers were made in contemplation of death, and some are favorable to the position of petitioner that decedent's motives in making the transfers were associated with life rather than with death.

Those circumstances which tend to indicate that decedent's motives in making the transfers were associated with death are as follows: (a) The advanced age of decedent when he made the transfers; (b) the amount of the property transferred by decedent in proportion to the amount of property retained by him; and (c) the fact that the donees were all the children of decedent, the natural objects of his bounty and the legatees in his subsequently executed will.

The circumstances which tend to indicate that decedent's motives were associated with life are as follows: (a) Decedent's health at or before the time of the transfers was good; (b) decedent's nature and disposition were cheerful, sanguine, and optimistic; (c) there was an interval of four years between the time of the transfers and the time of decedent's death;* (d) there was at the time of the transfers no testamentary scheme on the part of decedent, decedent's only will (so far as the record discloses) having been made four months after the transfers; (e) the decedent had over a long period of time made gifts to the same donees and in the same proportions as to each other; and (f) the decedent desired to escape the burdens incident to the management of the properties transferred.

The evidence is not compelling as to two pertinent circumstances; viz., the desire of the decedent to derive pleasure from the enjoyment by his children of the property transferred to them, and his desire to save estate taxes by such transfers. The record as a whole, however, justifies the inference that decedent did derive pleasure from the enjoyment by his children of the property transferred to them, and that decedent was in no way interested in the saving of estate taxes.

With regard to the three circumstances which tend to favor respondent's contention, two of them are subject to minimizing qualifications. While the amount of the property transferred by decedent was large in proportion to the amount retained by him, nevertheless, the amount of property retained was enough in his judgment to support him in the frugal manner of living to which he was accustomed and which he evidently preferred. While the donees were his children and, as such, the natural objects of his testamentary bounty, they were also for the same reason the natural objects of his donative bounty.

With regard to the circumstances tending to favor petitioner's contention, many of them are subject to amplification. For example, to say that decedent's health was good seems inadequate in view of the testimony concerning his health given by respondent's own witness, a chiropractor who gave treatments to decedent over a period of approximately a month in 1938 or 1939. He testified that decedent was "wonderfully preserved for a man of his age," that "he didn't look

* Since 1950, transfers made more than 3 years prior to death have been immune to attack by virtue of the final clause of §2035(b). — Ed.

his age by 12 or 15 years," that he was "a jolly old fellow," very alert and very spry, that he was active and carried himself like a young man, that after his treatments "his troubles seemed to be all over," and that he said "he was going to be here a long time." It is impossible to read the record here without concluding that the decedent in 1939 was, and had been, in extraordinarily good health; and, further, that he took an almost childish pride in his health and vigor.

The evidence is also most convincing in regard to decedent's desire to escape the burdens incident to the management of the properties transferred. The testimony of decedent's children that he had on several occasions made statements that he did not like the care of rental properties and wished to give them away as soon as he could clear the properties from liens is credible in the light of the facts. A retired farmer, 85 years old, enjoying his old age in Southern California, who was suddenly faced during the depression years with the necessity of managing a substantial number of rental properties and thus sacrificing his horseshoe pitching and woodwork, would most naturally have a desire to get rid of this unwanted responsibility as soon as he felt it possible for him to do so. Having gone through the vexing and trying experience of managing a large number of rental properties for some five years, it was natural for him to feel a revulsion against a continued responsibility for any rental property and to add the few rental properties which he had acquired prior to 1932 to the properties which he desired to transfer. And his decision in 1939 to include in the transfers of properties his farms in Kansas was consistent with a desire to shed responsibilities and concentrate on the pleasure of living. For a man 90 years of age to prefer to remain in Southern California with his family and his hobbies rather than to go during the summer months to the Kansas wheat country is a decision which would more reasonably result from considerations in regard to a pleasant place for living than from considerations in regard to death.

Certain evidence indicates that the children of decedent desired him to make the transfers in question. It is quite possible that *their* motives in desiring him to do so were associated with his death and were caused by *their* contemplation of his death, but their motives are irrelevant unless it is shown that decedent's will was substantially subordinated to theirs. The record indicates, however, that decedent's will was independently his.

Were it not for the decedent's advanced age at the time of the transfers here in issue, we would have little difficulty in concluding that the transfers were not made in contemplation of death. The one evidentiary circumstance as to which respondent stands on firm ground is that decedent at the time of the transfers was an old man, indeed an unusually old man.

It may be that the norm for the consideration of the mind and motives of a man 90 years of age is that of a man weakened by senility and subject to the continual and unmistakable physical intimations of approaching disintegration, with a consequent concentration on the spiritual and material problems posed by death.

If that is the norm, then we are convinced by the evidence before us that the decedent was not normal. The record in this case portrays an old man of far different characteristics. He was an old man of amazing vigor who enjoyed "showing off" that vigor to his children and friends (frequently to their annoyance). He was alert and independent, cheerful, and interested in living, and, above all, proud of his vitality and comparative youthfulness.

This portrait may not be an accurate likeness of the real Oliver Johnson. It is possible that the verbal picture of Oliver created at the trial by the testimony of witnesses brought out by the skillful guidance of petitioner's counsel empha-

sized certain of his features and left others in shadow to the extent that the Oliver Johnson of the verbal portrait has more resemblance to a synthesis of decedents whose transfers had been held in many reported cases to have been made not in contemplation of death than to the real Oliver Johnson who transferred real estate in Southern California on March 3, 1939.* But the judicial process requires that we create our image of Oliver from the material in the record before us. We can not be certain that our portrait of Oliver is a lifelike replica of the real Oliver, but we are confident that it accurately reflects the portrait of Oliver drawn by the evidence in this record.

When old age has brought with it to a decedent the normal results, that is, physical illnesses and mental preoccupation with mortality, old age may be a decisive test in determining whether transfers made by the decedent were prompted by thought of death. But where old age has not brought with it to a decedent these normal results, ". . . age in itself can not be regarded as furnishing a decisive test, for sound health and purposes associated with life, rather than death, may motivate the transfer." United States v. Wells [supra p. 1122]. . . .

In the instant case we have concluded from all the evidence that in spite of decedent's unusually advanced age the dominant and impelling motive of decedent in making the transfers here involved was not the thought of death, but was the desire to escape the burdens incident to the management of the properties transferred. Therefore our decision on the issue submitted is that the transfers were not made by decedent in contemplation of death.

Reviewed by the Court.

Decision will be entered under Rule 50.

Van Fossan, Murdock, and Arnold, JJ., concur only in the result. Turner, J., dissents.

NOTE

1. *Avoidance of estate taxes as a "death" motive.* In the *Johnson* case, the court said that "the existence of the desire by the decedent of avoiding estate taxes by means of making inter vivos transfers of property," if established, is one of the circumstances to be weighed in determining whether a transfer is in contemplation of death. The Regulations provide, more firmly, that a transfer "is prompted by the thought of death if . . . made with the purpose of avoiding death taxes" and that a transfer so prompted is made in contemplation of death. Regs. §20.2035-1(c). In Denniston v. Commissioner, 106 F.2d 925, 928 (3d Cir. 1939), however, the court said:

> We think that because in carrying out a plan to provide for her children the donor uses a method which she thinks is best calculated to save death taxes the conveyance is not thereby conclusively stamped as "in contemplation of death." The desire to avoid estate taxes may be just as clearly present in the mind of a young and vigorous donor who thinks of death as far distant as in that of one who is old and feeble and who looks momentarily for its coming. Standing alone it cannot be deemed conclusive of a mental state such as is contemplated by the statutory phrase "contemplation of death."

But the same court later affirmed, per curiam, a decision in which the district court had said:

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* In Galt v. Commissioner, 216 F.2d 41 (7th Cir. 1954), the court quotes a letter written by the taxpayer to his sons on giving them certain interests in sums to become due under a lease. One paragraph of the letter reads as follows: "I am now in my sixties and never felt better or was in better health in my life than I am at this date, and as I come from a long lived family — my father having died at about ninety-two, I fully expect to live during the entire life of the lease [20 years], and share with you the fullest association of our mutual company." — Ed.

> On these facts, we can draw no other conclusion than that the transfer was made with intention that these properties should not be liable for Federal estate tax. If that is so, naturally the transfer must have been made in contemplation of death. [Commonwealth Trust Co. v. Driscoll, 50 F. Supp. 949, 951, aff'd, 137 F.2d 653 (3d Cir. 1943), cert. denied, 321 U.S. 764 (1944).]

In Allen v. Trust Co. of Georgia, 326 U.S. 630 (1946), the Supreme Court affirmed a judgment in a case in which the district court had held that a release of a power to amend certain trusts was not in contemplation of death, even though the only reason for the release was to avoid the federal estate tax. The decedent had created two spendthrift trusts during his lifetime for the benefit of his children. Because they had suffered financial reverses and were heavily in debt, he intended to insulate the trust property against any tax or other claims that might arise. He retained a power to amend the trusts with the consent of the trustee and beneficiaries, believing that the retention of such a power would not require the property to be included in his gross estate. In 1935, however, the Supreme Court held in the *City Bank Farmers Trust Co.* case (infra p. 1158) that the reservation of such a power did bring trust property into the gross estate; and in 1937, to avoid this result, the decedent released his power to amend the trusts. The government argued that the property must be included in the gross estate because the release was motivated solely by an intent to avoid the estate tax,* but the Supreme Court said:

> But that is to isolate the release from all that preceded and to treat it as a wholly independent transaction. This is not a case where a settlor, having made one plan for the disposition of his property, later makes a different one to avoid death taxes. Mr. Spalding, in making the release, did what he originally intended to do — to make complete and absolute gifts to his children, freed of all claims, including taxes. Retention of the power to amend would have brought the trust property into Mr. Spalding's estate and subjected it to the estate tax lien. His purpose to take care of his children, come what may, might thus have been thwarted or impaired. He guessed wrong on the law, when he retained the power to amend. When he rectified the error, he was in good faith, endeavoring to complete his original project, not to give his children more than he at first intended in order to save taxes. What he did in 1937 was merely to accomplish by an additional step what he assumed he had already done. . . . On these facts, his desire to avoid death taxes does no more than establish that he did not want his plan to underwrite the necessities of his children and grandchildren jeopardized. His desire to make adequate provision for them remained the dominant motive, or so the triers of fact could properly find. [326 U.S. at 636-637.]

Note that the decedent's original purpose "to take care of his children, come what may" could have been jeopardized only if the estate tax could not have been paid out of the rest of his property. If the purpose of the *original* transfer had been to protect his children against estate tax and other claims, would the later transfer be in contemplation of death? See McIntosh's Estate v. Commissioner, 248 F.2d 181 (2d Cir. 1957) (*Trust Co. of Georgia* case not applied where earlier transfer was itself intended to avoid estate tax); Wardwell's Estate v. Commissioner, ¶61,295 Memo T.C. (applying *Trust Co. of Georgia* case).

Does the *Trust Co. of Georgia* case imply that a desire to avoid estate tax is a "death" motive even though the transferor is in perfect health and has no more than "that general expectation of death such as all persons entertain" which according to Regs. §20.-2035-1(c) is not encompassed by the statutory phrase "contemplation of death"?

2. *Relation of transfer to testamentary plan.* The *Johnson* case refers to "the existence of a general testamentary scheme of which the transfers were a part" as indicative of a gift in contemplation of death. What does this do to the process of "estate planning"? See Davidson's Estate v. Commissioner, 158 F.2d 239 (10th Cir. 1946) (gifts in

* If property would be included in the gross estate because the decedent retained a power to amend the provisions of the trust, it must also be included if the decedent relinquished such a power in contemplation of death. §2038(a)(1) and (2).

trust contemporaneous with execution of will; held, "integrated parts of a single plan, testamentary in nature"); Purvin v. Commissioner, 96 F.2d 929 (7th Cir. 1938), cert. denied, 305 U.S. 626 (reference in will explaining that no bequests were made to certain persons because testator had "already made provision for them in another manner during his lifetime"; held, evidence that the earlier transfers were part of a comprehensive testamentary plan). See Cleary, Protecting the Family Through Estate Planning, 25 Taxes 543, 551 (1947):

> Decisions such as this [Davidson's Estate v. Commissioner, supra] indicate the danger of a holding that inter-vivos transfers are made in contemplation of death where an intelligent over-all plan, carefully worked out, involves both inter-vivos transfers and testamentary dispositions and correlates the two in any way.
>
> The situation makes effective estate planning difficult. It is hardly possible for the parties to close their eyes to the estate tax consequences of inter-vivos gifts. It seems impracticable, if not blameworthy, to refrain from calling to the client's attention these highly important tax factors. Well-advised counsel cannot discuss estate planning problems without mentioning the possibility that transfers may be held to be made in contemplation of death. Suppression or concealment of computations, correspondence, or advice, certainly is not a satisfactory solution.
>
> Yet, as a practical matter, we know that people must plan. As the Supreme Court recognized in the *Trust Company of Georgia* case, one cannot fail to know that if he gives away property in his lifetime, he at least will not be the owner of that property at the time of his death. We also know that, by and large, the government has had rather hard going in the contemplation-of-death case, notwithstanding the language in the cases.
>
> The objective of sound estate planning, therefore, must be to make inter-vivos transfers primarily for motives associated with life, and to keep such records of the decedent's motives that it can be proved that the dominant motive for the transfer was associated with life. Furthermore, in the correspondence and computations care should be taken to emphasize the income tax savings and the motives associated with life. The uncertainties as to the possible estate tax savings should be specifically pointed out — for example, the discount factor, the possible early death of the donee, the possible depreciation in the value of the property during the donor's life, the possibility of reductions in rates, etc. There is, I think, a tendency to overstate and emphasize improperly the potential estate tax savings, a tendency which certainly should be avoided.

3. *Transfers animated by mixed motives.* In Farmers' Loan & Trust Co. v. Bowers, 98 F.2d 794 (2d Cir. 1938), cert. denied, 306 U.S. 648, the government showed that William Waldorf Astor made a transfer in England in 1919 that was motivated in part by a desire to avoid United States income and estate taxes and in part by a fear that England, where he lived, would enact a capital levy. Avoidance of the federal estate tax was a substantial motive for the transfer, but it may not have been the dominant motive, and the taxpayer argued that the trial judge committed error in charging the jury that if "the motive of avoiding the estate tax played a substantial part in causing Astor to make the transfers, the transfers must be held to have been made in contemplation of death." The Court of Appeals held that the charge was correct. After quoting extensively from the *Wells* case, the court said:

> While the Supreme Court may have intended to lay down the rule that even a substantial death motive would not bring a case within the statute if the dominant motive was to relieve the settlor of care, to give his children experience in managing their own affairs, to settle property upon them during his lifetime, or to carry out some other beneficent purpose, we do not think such a rule extends to a situation where a substantial motive to avoid estate taxes is accompanied by motives to escape other kinds of taxation. These remaining motives, though lawful, can hardly be regarded as reasons for engrafting exceptions upon a statute taxing transfers made in contemplation of death generally. These motives differ greatly from the beneficent purposes listed in the *Wells* case and are neither included in the statute as grounds of exception, nor made such under any decision. [98 F.2d at 798.]

Before the *Astor* case was decided, the Regulations had provided that "the more compelling motive controls" if the transfer results from mixed motives. Regs. 80, Art. 60. The Regulations were then changed to provide, as now, that a transfer is reached by §2035 if it is "prompted by the thought of death (although it need not be solely so prompted)." Regs. §20.2035-1(c).

4. *Transfers of non-productive property.* Another factor that may lead to the conclusion that a gift was made in contemplation of death is that no income will be produced by the transferred property before the transferor dies. See Reeves' Estate v. Commissioner, 180 F.2d 829 (2d Cir. 1950), involving a transfer of corporate stock on which no dividends were paid until the transferor's death, although the corporation's earnings were substantial: "From this fact, and from decedent's always powerful, if not always mathematically controlling interest in the corporation, the commissioner inferred an intent not to pay dividends so long as decedent managed the affairs of the corporation." The Tax Court's holding that the gift was made in contemplation of death was affirmed, since "the record is bare of any explanation which makes the Commissioner's position seem unreasonable." The suggestion that a transfer of non-income-producing property is necessarily in contemplation of death, at least if the transferee is unable to sell the property and invest the proceeds in income-producing property, apparently derives from cases dealing with transfers of life insurance policies. Infra page 1249.

5. *Credit for gift tax paid.* An inter vivos transfer is subject to the federal gift tax even though the value of the transferred property is later included in the donor's gross estate as a transfer in contemplation of death. The gift tax paid on the transfer will ordinarily be credited against the estate tax, however, as though it were a down payment on the estate tax liability, although in some instances the credit — because of changes in value between the time of the gift and the date of death, or because the gift tax rate is higher than the applicable estate tax rate — will not equal the full amount of the "down payment." The gift tax credit is examined infra page 1330.

Because the gift tax paid by the donor, as distinguished from the gift itself, is not added back to the gross estate, the total transfer tax burden may often be reduced by a lifetime gift even though it is certain to be thrown back into the gross estate under §2035. To illustrate this principle by a dramatic example, assume that A's entire fortune consists of $10 million, and that he makes an inter vivos gift of $7.1 million. The gift tax (assuming no prior taxable gifts) will be about $2.9 million, which will exhaust the balance of A's original $10 million. If the transfer is a gift in contemplation of death, A's gross estate will be $7.1 million, on which the estate tax will be about $3.9 million, less a gift tax credit of $2.9 million, leaving a balance due of $1 million. There being no probate assets in A's estate, the tax will be collectible out of the donated property. Thus, A's donees will be left with $6.1 million after taxes. (If A survives for more than three years after making the gift, §2035(b) will protect the donees against having the gift included in the gross estate, with the result that there will be no estate tax and the donees will retain their $7.1 million free and clear.) By contrast, had A retained the property until his death, the federal estate tax would have been about $6 million, leaving $4 million for the heirs.

Note how, in the example just described, the amount paid by A as federal gift tax is excluded in computing the amount of the inter vivos gift as well as in computing his gross estate.

6. *Executor's duty to report transfers.* In addition to requiring the executor to report any transfers by the decedent that are includible in the gross estate, the estate tax return (Form 706, Schedule G) asks whether "the decedent, within 3 years immediately preceding his death, [made] any transfer of his property without an adequate and full consideration in money or money's worth." How full an investigation must the executor make before answering this question? The return goes on to ask for the details of any such transfer of $1000 or more May the executor properly search only for transfers of this size?

7. *Income tax aspects of gifts in contemplation of death.* As already noted (supra p. 1074), the income tax basis of inherited property is its value as of the decedent's death (or on the optional valuation date if that is used, infra p. 1335). Before 1954, this rule was not applicable to gifts in contemplation of death, since the applicable provision

(§113(a)(5) of the 1939 Code) was limited to property "acquired by bequest, devise, or inheritance." But §1014 of the 1954 Code greatly expands the categories of property whose basis shifts at death, including gifts in contemplation of death. If the donated property is sold *before* the donor's death, however, its income tax basis is prescribed by §1015 (donor's basis); so that the donee's income tax may be substantially affected by his timing. If he sells shortly after the decedent's death, moreover, he may not know until months or years later whether his income tax basis should be determined under §1014(b)(9) or under §1015. If a transfer was not taxed to the estate as a gift in contemplation of death, may the donee (perhaps many years later) assert that it should have been included in the gross estate and that he is entitled to a stepped-up income tax basis for the property?

A conflict of interest between the estate and the donee may arise if the government asserts that a transfer was made in contemplation of death, since the estate tax burden on the estate may be less than the income tax savings that the donee would derive from a stepped-up basis.

In Rev. Rul. 59-86, 1959-1 C.B. 209, the Internal Revenue Service held that the holding period of a capital asset received by gift begins on the date of gift, even though the property is later included in the donor's estate as a gift in contemplation of death so that its basis to the donee is governed by §1014.

8. *Proposals for legislative changes in §2035.* The model estate tax statute drafted for the American Law Institute (Tent. Draft No. 9) proposes that the present statutory scheme be continued with the period lengthened to 5 years or, as an alternative, that all gifts within 3 years of death be subjected to estate tax. The latter proposal assumes that Heiner v. Donnan, supra page 1121, would either not be followed today or would be distinguished because the proposal does not use the language of presumption. See the *Bullard* case, infra page 1180. Among many other proposals for legislative action in this area are those by Paul, Hearings, House Ways and Means Committee, 77th Cong., 2d Sess. 91 (conclusive presumption for transfers within 2 years of death by person over 65, if in excess of some specified sum); Lowndes and Rutledge, infra (transfer includible if a reasonable man in decedent's position "would have realized that he had no substantial life expectancy"); Pavenstedt, infra (repeal proposed; or 2-year conclusive presumption applicable to persons over a specified age).

9. *References.* Barry, The Taxation of Transfers in Contemplation of Death, 10 Hastings L.J. 370 (1959); Lowndes and Rutledge, An Objective Test of Transfers in Contemplation of Death, 24 Texas L. Rev. 134 (1945); Pavenstedt, Taxation of Transfers in Contemplation of Death: A Proposal for Abolition, 54 Yale L.J. 70 (1944); Atlas, Gifts in Contemplation of Death, 23 Taxes 421 (1945).

FRIZZELL'S ESTATE v. COMMISSIONER
9 T.C. 979 (1947)

[The decedent created an irrevocable trust in 1937 for the benefit of his son by transferring 1132 shares of common stock of the Coca-Cola Company to the Trust Company of Georgia. He died in 1940. In an omitted part of the opinion, the court held that the trust was created in contemplation of death.]

HARRON, Judge: . . .

Issue 2. — Upon the holding that the decedent created the trust for his son in contemplation of death and as a substitute for a testamentary disposition, a second question arises, which relates to the measure of the resulting estate tax. That is to say, the problem is to determine the value of "property" to be included in the gross estate for purpose of measuring the estate tax. Respondent included the value of the trust corpus at the date of death, which consisted of the original corpus, the gift stock of the Coca-Cola Co., plus increases in the corpus resulting from investment of undistributed income, and cash not yet invested. The petitioners contend that the value of only part of the trust is includible in the gross estate, namely, the value of the Coca-Cola stock. The amount of the difference

in value involved in the respective contentions of the parties is about $11,228.

The question presented is one of first impression, relating as it does to a transfer in trust which was made in contemplation of death but was completed in every respect when the inter vivos transfer was made, and was not one in which the decedent retained any interests in the property transferred. In the *Igleheart* case [77 F.2d 704], it appeared in the findings of fact made by the Board of Tax Appeals that reinvestments of trust corpus had been made by the trustee between the date of transfer and the date of death, but that fact was not discussed by the Circuit Court in Igleheart v. Commissioner, supra, and, although the Circuit Court sustained the Board's holding that the value of all of the assets of the trust at the date of death should be included in the gross estate, there was no issue raised, as is raised here, on the point that the value of the trust assets to be included in the gross estate should be limited to the value at the date of death of the property transferred in trust by the grantor, the decedent. Also, in this case, the question does not relate to reinvestments by the trustee of proceeds from the original property transferred by the grantor-decedent to a trust in contemplation of death, nor to accretions to the very property which the grantor-decedent transferred to the trust during his lifetime. We are unable to find, and neither party has cited, any authority which has considered the precise question presented in this case. Petitioners cite no authorities to support their contention and confine their argument on brief to reliance upon the literal wording of [§2035].

Under the holding in issue 1, the shares of Coca-Cola stock are property to be included in the gross estate for computing the tax upon the estate. Except for petitioners' position under issue 1, as it carries over to this issue, there is no real dispute with respect to this conclusion. Thus the question which is in dispute relates primarily to the other property which made up the trust corpus at the date of death, and the question is whether such other property is includible in the gross estate under the holding that the transfer in trust at the time the trust was created was made in contemplation of death under [§2035]. . . .

The trust instrument under which this trust was created did not evidence any retention of interest in the decedent from which it could be held that his death operated to end any probabilities or contingencies upon the happening of which any interests in any of the property of the trust would become certain. This trust is distinguishable from the trusts in the cases of Fidelity-Philadelphia Trust Co. v. Rothensies, 324 U.S. 108, and Commissioner v. Field, 324 U.S. 113, where it was held that "the retention of such a string . . . , subjected the value of the entire corpus to estate tax liability." Fidelity-Philadelphia Trust Co. v. Rothensies, supra. Here, the gift of the decedent to the trust was completed in every respect during his lifetime and was not affected by his death. Only the testamentary character of the motive of the decedent in making the gift sweeps it into his estate under [§2035] relating to transfers made in contemplation of death. The phrase "in contemplation of death," used in the statute, which governs the present case, "embraces gifts inter vivos, despite the fact that they are fully executed, are irrevocable and indefeasible." United States v. Wells [supra p. 1122]. But we do not perceive that the motive, contemplation of death, of the gift in trust of one property sweeps into the gross estate other property which is found in the trust at the date of death which is derived from the operation of the trustee, independently of the grantor, in his discretionary accumulation of income and the investment thereof in new property.

The estate tax is a tax on a transfer; it is not a tax on property. United States Trust Co. of New York v. Helvering, 307 U.S. 57; Chase National Bank v. United States, 278 U.S. 327, 334; Central Hanover Bank Co. v. Kelly, 319 U.S. 94; Milliken v. United States, 283 U.S. 15, 20, 22, 23. Although in the instance of prop-

erty transferred in contemplation of death all interests have been completely determined upon the making of the inter vivos transfer and the property does not technically pass at death, the statute, for purposes of the estate tax, puts the property transferred in contemplation of death in "the same category as it would have been if the transfer had not been made and the transferred property had continued to be owned by the decedent up to the time of his death." Igleheart v. Commissioner, supra. It was stated in Helvering v. Hallock, 309 U.S. 106: "Section 302(c) [Revenue Act of 1926, applying both to transfers in contemplation of death and to transfers taking effect at death] deals with property technically passing at death but with interests theretofore created. *The taxable event is the transfer inter vivos. But the measure of the tax is the value of the transferred property at the time when death brings it into enjoyment.*" (Italics supplied.) This rule is, in our opinion, the decisive consideration in the question before us. Value at the time of death provides the measure of the tax, but the tax is upon a transfer of property. Helvering v. Hallock, supra. Therefore, we think that where *transfer* of property has been completed during life and the death of the grantor does not operate upon the completion of the transfer, the estate tax is measured by the value of the property which the decedent transferred to a trust, only, and the tax is not measured by other property in the trust when death occurs. The fact that transfers are made in *trust* may constitute one common element in both a transfer in contemplation of death and a transfer taking effect at death. In both, a trust holds property at the time of death which is to provide the measure of the estate tax, but the differences in law between the two classes of transfers dictate the differences in the measure of the tax. Perceiving this to be the underlying distinction . . . for purposes of determining gross estate, it follows here that the "property" to be included in decedent's gross estate is only the value at the date of death of the Coca-Cola stock of which the decedent made transfer during his life, rather than the value of the entire trust corpus, as respondent has determined.

The conclusion above reached is not in conflict with the holding in Estate of Daniel Guggenheim, 40 B.T.A. 181, 182, 183 (modified and affirmed, 117 Fed. (2d) 499; certiorari denied, 314 U.S. 621). In the *Guggenheim* case the entire trust corpus was included in the decedent's gross estate because of the reserved powers retained up to the time of his death, a different situation than we have here, where the decedent retained no interest in nor control over the property which he transferred in trust. . . .

It is held that there should be included in the gross estate under [§2035] only the value of the shares of Coca-Cola stock which the decedent transferred to the trust, and that respondent erred in including in the gross estate the value of other property in the trust at the date of death which the trustee acquired after the trust was created out of his accumulations of trust income.

Reviewed by the Court.

NOTE

1. *Other trust cases.* The *Frizzell* case was affirmed, sub nom. Burns v. Commissioner, 177 F.2d 729, 741 (5th Cir. 1949), the court saying:

> We further sustain the holding of the Tax Court on the cross-petition that only the value of the Coca-Cola stock transferred was properly includible in decedent's gross estate, and not the value of the other securities and property acquired from accumulations of trust income comprising a part of the trust corpus at his death. The tax statute in question should be strictly construed in favor of the taxpayer, and since it does not expressly provide for the inclusion of income derived from the

transferred property in the gross estate, it is not our prerogative, by judicial fiat, to give it that effect.

In the *Igleheart* case, cited by the Tax Court in *Frizzell,* the rationale for including the value of the corpus of the trust at the date of death, rather than its value at the time of the gift, was expressed as follows:

> For the purposes of the tax, property transferred by the decedent in contemplation of death is in the same category as it would have been if the transfer had not been made and the transferred property had continued to be owned by the decedent up to the time of his death. [77 F.2d 704, 711.]

See also McGehee v. Commissioner, 260 F.2d 818 (5th Cir. 1958) (stock dividends paid out of post-gift income not includible); Comment, Estate Tax Includibility of Stock Dividends on Shares Transferred in Contemplation of Death, 25 U. of Chi. L. Rev. 372 (1958).

2. *Non-trust transfers.* In Humphrey's Estate v. Commissioner, 162 F.2d 1 (5th Cir. 1947), cert. denied, 332 U.S. 817 (1947), the court held that a gift of cash in contemplation of death was includible in the donor's estate at its full amount even though part of it was lost by the donee in a business venture before the donor's death:

> The evident purpose is to make the transferred property cause the same tax result as if the decedent had kept it till he died instead of transferring it. We do not accede to the argument that if the transferee injures or makes away with it, it shall be considered that he has acted as the agent of the decedent, or that he may substitute it by other property of less value. What is to be valued at the time of decedent's death is the very property which the decedent transferred. [162 F.2d at 2.]

What if the funds had been given to the donee on an understanding that they would be invested in the venture that turned out to be a failure? If the gift consists of securities, and the donee sells them before the donor's death, is the includible amount their value at the time of the gift, the sales price, the value of equivalent securities at the donor's death, the value of any reinvestments made by the donee, or some other amount?

SULLIVAN'S ESTATE v. COMMISSIONER
175 F.2d 657 (9th Cir. 1949)

Before DENMAN, Chief Judge, and STEPHENS and ORR, Circuit Judges.

DENMAN, Chief Judge:

This is a petition to review a decision of the Tax Court which upheld the Commissioner's determination of deficiencies in the petitioner's estate tax return. Two questions are presented for review: (A) Is the amount of a gift by two joint tenants, husband and wife, to their son, in contemplation of the husband's death, includible in its entirety in the husband's gross estate under [§2035]. (B) Where two joint tenants agree to terminate a joint tenancy and henceforth hold the property as tenants in common and transfer each to the other the interest held by each, and this is done in contemplation of death of the decedent, is the entire amount of the property to be included in the gross estate of the deceased joint tenant under [§2035].

All property of decedent and his wife had been held in joint tenancy except for one small parcel of realty held in decedent's name alone. The gift to the son of the wife's and husband's interest in the joint tenancy was made when decedent was 77 years old and suffering from an ailment which caused his death within two months after the gift was made. The termination of the joint tenancy was accomplished by the contract between the spouses a few days later, and at the same time the revision of the wills of decedent and his wife was discussed. A week later new wills were executed by decedent and his wife. This evidence supports the finding

that both the gift to the son and the termination of the joint tenancy were joined in by decedent in contemplation of his death. . . .

A. The Tax Court erred in including the entire joint estate in the gift to the son because, under the California law, he could transfer only a half interest therein.

It has long been established that what constitutes an interest in property held by a person within a state is a matter of state law. Fernandez v. Wiener, 326 U.S. 340, 355-357, determining by Louisiana law what is transferred of community property on the death of the husband and the shiftings of interest between the two spouses. Moffitt v. Kelly, 218 U.S. 400.

One of the factors in an owner's interest in property is the owner's power to transfer it. Congress has the power to impose an excise tax on the transfer when made, but has not enacted any law taxing gifts which determines the quantum of the transfer and thereby makes the state law not controlling.

Under the law of California, one joint tenant cannot dispose of anything more than his own interest in the jointly held property. People v. Marshall, 8 Cal. 51; Oberwise v. Poulos, 124 Cal. App. 247, 12 P.2d 156. "During the lives of the tenants, the rules regulating the transfer of their interests are substantially the same, whether they hold in joint tenancy or in common. Neither a joint tenant nor a tenant in common can do any act to the prejudice of his co-tenants in their estate." Stark v. Barrett, 15 Cal. 361, 368. Where a joint tenant has purported to convey more than his interest, his transferee is held to have taken only the interest that could be transferred, i.e., the transferor's share. Stark v. Barrett, supra; Swartzbaugh v. Sampson, 11 Cal. App. 2d 451, 54 P.2d 73.

It is obvious that the half interest conveyed by the wife was not in contemplation of death. She is still living.

The decision of the Tax Court is reversed on the issue of the gift to the son.

B. The Tax Court erred in holding that, although the joint tenancy was terminated by the contract of decedent and his wife prior to his death, it is taxable under [§2035] and [§2040] of the Internal Revenue Code.

Section [2035]. The pertinent portions of the contract are:

"Now, therefore, it is agreed as follows:

"First: That from and after this date all of the real and personal property owned by the parties hereto, whether presently held in joint tenancy or presently owned by either of the parties hereto in his or her own name, shall be owned by each of the parties as follows:

"An undivided one-half interest therein shall be the separate property of Frank K. Sullivan, and Hattie B. Sullivan hereby assigns and transfers to Frank K. Sullivan all of her right, title and interest in and to an undivided one-half interest in the same.

"An undivided one-half interest therein shall be the separate property of Hattie B. Sullivan, and Frank K. Sullivan hereby assigns and transfers to Hattie B. Sullivan all of his right, title and interest in and to an undivided one-half interest in the same."

This contract between the spouses either ipso facto terminated the joint estate of the spouses, cf. McDonald v. Morley, 15 Cal. 2d 409, 101 P.2d 690, or it was terminated by the stated transfers inter se of the interests of each of the spouses.

If the contract ipso facto terminated the joint tenancy, without the transfer inter se, it is not taxable under [§2035], which covers only "Transfers in contemplation of . . . death." If, on the other hand, the contract be construed to involve a transfer, it was a bona fide transfer for money's worth because the younger wife's joint interest transferred to the older husband is worth at least as much as the husband's interest transferred to her.

The Commissioner contends that the sale was not "bona fide" because made in contemplation of death. The wording of the statute shows the contrary, the pertinent portions reading:

> (a) Decedent's Interest. — To the extent of the interest therein of the decedent at the time of his death; . . .
>
> (c) Transfers in contemplation of, or taking effect at death. — To the extent of any interest therein of which the decedent has at any time made a transfer, by trust or otherwise, in contemplation of or intended to take effect in possession or enjoyment at or after his death, . . . except in case of a bona fide sale for an adequate and full consideration in money or money's worth.*

The Commissioner also contends that it was not bona fide because the negotiations between the spouses were not at "arms' length." There is no evidence to support such a contention. The actual contract is such a fair one to each, that it is of the sort which would be the result of arms' length bargaining.

The Commissioner also contends that under [§2035] any transfer in contemplation of death is taxable because it, to that extent, reduces the decedent's estate at his death. The face of the section shows the contrary and the Supreme Court has so held. There was no compulsion on the co-tenants to continue the joint tenancy so that this taxable event would occur. "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits cannot be doubted." Gregory v. Helvering, 293 U.S. 465, 469. "A taxpayer may arrange his business transactions so they may or may not be taxable under the phraseology of the taxing act." Pacific Southwest Realty Co. v. Commissioner, 9 Cir., 128 F.2d 815, 818.

The Tax Court and the Commissioner rely on the cases of Igleheart v. Commissioner, 5 Cir., 77 F.2d 704; In re Kroger's Estate, 6 Cir., 145 F.2d 901; Estate of Hornor, 44 B.T.A. 1136 and Estate of Koussevitsky, 5 T.C. 650, as authority for the inclusion in decedent's gross estate of any joint property owned prior to decedent's death and transferred in contemplation of death. The factual situations presented in those cases do not resemble the instant case. No one concerned a bona fide transfer for money's worth under [§2035].

Section [2040]. This is a provision not in any way concerned with transfers in contemplation of death, that element of the estate tax statute being disposed of in [§2035]. . . .

As seen above, the joint tenancy was terminated before the husband's death. Hence, as to the joint tenancy, the deceased had no "interest therein . . . at the time of his death."

As stated in United States v. Jacobs, 306 U.S. 363, in considering [§2040] . . . "Congress has the power to levy a tax upon the occasion of a joint tenant's acquiring the status of survivor at the death of a co-tenant," and 306 U.S. at page 371, "Until the death of her co-tenant, the wife could have severed the joint tenancy and thus have escaped the application of the estate tax of which she complains . . ."

The Commissioner agrees that [§2040] has no application, adding respecting the Tax Court's finding "Obviously, that finding is one which is solely designed to bring both the gift and the contract within the contemplation of death provisions of [§2035]. By contrast, there is no finding either circumstantial or otherwise which would justify the inclusion of the value of the property in the decedent's gross estate under [§2040], so that on its face the taxpayer's contention does violence to the Tax Court's findings and its decision which is based thereon."

* These provisions are §811(a) and §811(c) (in part) of the 1939 Code, corresponding to §2033 and §2035 of the 1954 Code. — ED.

The decision of the Tax Court is reversed as to the issue of inclusion in the estate tax of the wife's separate property, and the case remanded to the Tax Court for its further adjudication in accord with this opinion.

Reversed.

STEPHENS, Circuit Judge, did not participate in the decision of this case.

NOTE

1. *Transfer of jointly held property in contemplation of death.* The court states that the decedent had no "interest . . . at the time of his death" in the property that had previously been held in joint tenancy. Does §2040 require that the joint tenancy exist at the time of the decedent's death? The phrase "interest . . . at the time of his death" appears in §2033 (formerly §811(a) of the 1939 Code), not in §2040 (§811(e) of the 1939 Code). The Regulations, however, refer to property "held jointly at the time of the decedent's death." Regs §20.2040-1(a).

What would have been the result in *Sullivan* if the surviving spouse was the economic source of the entire property? Nothing would have been included in the husband's estate under §2040 if the joint tenancy had continued, but would the conveyance be treated as a transfer in contemplation of death of his interest in the property?

For other problems in this area, see page 1192 infra.

2. *Conversion of community property into separate property.* In Rickenberg v. Commissioner, 177 F.2d 114 (9th Cir. 1949), cert. denied, 338 U.S. 949 (1950), it was held that an agreement between husband and wife converting their community property into a tenancy in common did not constitute a "transfer" by him within the meaning of §2035 because each spouse had a one-half interest in the community property before the conversion, so that the government's allegation that the agreement was made in contemplation of death was immaterial. (Had it not been for the agreement, all of the community property would have been included in the estate of the husband, under the 1942-1948 "economic source" rule (supra p. 1107); and the government sought to achieve the same result by disregarding the agreement as a transfer in contemplation of death.) By the same agreement, they converted certain so-called "pre-1927 California community property" into a tenancy in common; because this species of community property is, for reasons peculiar to California law, treated as separate property of the husband for federal tax purposes, the agreement was held by the court to constitute a transfer by the husband to the wife of a one-half interest in the property, and the transfer was found to be in contemplation of death because it was made "solely in order to minimize estate taxes in the event the husband died first."

3. *References.* Wright, Transfers of Joint Property in Contemplation of Death, 55 Mich. L. Rev. 1 (1956); Note, Joint Tenancy and Estate Tax Avoidance: A Widening Loophole for Transfers in Contemplation of Death, 66 Yale L.J. 142 (1956).

SECTION B. REVOCABLE TRANSFERS: §2038

From 1916 to 1924, the estate tax statute did not refer specifically to revocable transfers, but they were includible in the gross estate by virtue of a clause reaching any transfer by trust or otherwise "intended to take effect in possession or enjoyment at or after death." Moreover, it was held that revocable transfers made before 1916 could be reached, if the transferor died after 1916; the claim that to include such property in the gross estate was retroactive legislation in violation of the due process clause of the Fifth Amendment was rejected on the ground that the transfer was not complete until the transferor's death and that the tax was imposed on the shifting of economic benefits at death. Reinecke v. Northern Trust Co., 278 U.S. 339 (1929).

In 1924, the prototype of what is now §2038 was enacted, reaching transfers where enjoyment was subject at the date of the decedent's death "to any change through the exercise of a power, either by the decedent alone or in conjunction

with any person, to alter, amend, or revoke, or where the decedent relinquished any such power in contemplation of his death. . . ." This provision was changed from time to time after 1924, and took on its present form in 1936. Some of the post-1924 changes, as will be seen, were declaratory rather than substantive.

1. *Where Grantor's Power Is Unrestricted*

Over the years, the Internal Revenue Service has construed §2038 in an expansive manner and it has met with few setbacks along the way. In Porter v. Commissioner, 288 U.S. 436 (1933), the Supreme Court held that §2038 brought into the gross estate a trust over which the decedent had a nonbeneficial power to amend, i.e., a power to modify or alter the trust indenture in any manner except in favor of himself or his estate. The Court held that §2038 was intended by Congress to reach property in which the decedent had no "interest" of the type that would be subject to §2033, and that the terms "alter" and "amend" in §2038 were not used as synonyms for "revoke." The Court said:

> We need not consider whether every change, however slight or trivial, would be within the meaning of the clause. Here the donor retained until his death power enough to enable him to make a complete revision of all that he had done in respect of the creation of the trusts even to the extent of taking the property from the trustees and beneficiaries named and transferring it absolutely or in trust for the benefit of others. So far as concerns the tax here involved, there is no difference in principle between a transfer subject to such changes and one that is revocable. [288 U.S. at 443.]

The Court also rejected the argument that so construed, §2038 measured the decedent's tax by property belonging to others, in violation of the due process clause:

> [The taxpayers] treat as without significance the power the donor reserved unto himself alone and ground all their arguments upon the fact that deceased, prior to such enactment, completely divested himself of title without power of revocation. It is true that the power reserved was not absolute as in the transfer considered in Burnet v. Guggenheim [supra p. 1007], in which this court, in the absence of any provision corresponding to [§2038], held that the donor's termination of the power amounted to a transfer by gift within the meaning of §319 of the Revenue Act of 1924, 43 Stat. 313. But the reservation here may not be ignored, for, while subject to the specified limitation, it made the settlor dominant in respect of other dispositions of both corpus and income. His death terminated that control, ended the possibility of any change by him, and was, in respect of title to the property in question, the source of valuable assurance passing from the dead to the living. That is the event on which Congress based the inclusion of property so transferred in the gross estate as a step in the calculation to ascertain the amount of . . . the net estate. Thus was reached what it reasonably might deem a substitute for testamentary disposition. United States v. Wells [supra p. 1122]. There is no doubt as to the power of Congress so to do. [288 U.S. at 444.]

In Commissioner v. Chase National Bank, 82 F.2d 157 (2d Cir. 1936), cert. denied, 299 U.S. 552, §2038 was held applicable to an irrevocable trust created by the decedent during her lifetime, in 1920, under which the corpus and undistributed income would be paid on her death to her lawful descendants in such proportion as she should appoint by will, or in equal shares per stirpes in default of such an appointment:

> We think [§2038] authority for the inclusion of the trust corpus in the decedent's gross estate. Up to the time she died she had the power to alter the proportions in which her descendants should take the property in accordance with the original terms of the trust instrument. She could have limited any, or all but one, of them to a nominal amount and given all of real value to one or to such of them as she pleased.

Her death eliminated the possibility of any such change in the provisions of the deed of trust and made it certain that her lawful descendants would take the property in equal shares per stirpes. The power she reserved was not to change the trust provisions in a trivial way, but went right to the heart of them and gave the decedent a substantial though qualified control over the trust property until her death. Such a power to alter or amend the substance of the transfer by trust brought it within the scope of the decision in Porter v. Commissioner [supra p. 1144], and justified the inclusion of the property in the gross estate of the decedent. . . . The decedent, having the right to change the economic benefit, had the power to alter within [§2038] even though she could not benefit herself in a pecuniary way by the change. Witherbee v. Commissioner (C.C.A.) 70 F.(2d) 696. She lived several years after the act took effect and she was on notice of its provisions, retaining the reserved powers when she might have given them up to rid her estate of this tax liability. So there has been no denial of rights under the Fifth Amendment. [82 F.2d at 158.]

A further step was taken in Commissioner v. Estate of Holmes, 326 U.S. 480 (1946), where the decedent during his lifetime had created three irrevocable trusts, one for each of his sons. He retained for his lifetime the power to terminate each trust; if this power was exercised, the trust corpus and accumulated income would go to the son if living, otherwise to the son's surviving issue if any; if the son had no surviving issue, the property went to the other two sons or their surviving issue per stirpes, with ultimate gifts over. The Court held that the decedent had a power to "alter, amend, or revoke":

It seems obvious that one who has the power to terminate contingencies upon which the right of enjoyment is staked, so as to make certain that a beneficiary will have it who may never come into it if power is not exercised, has power which affects not only the time of enjoyment but also the person or persons who may enjoy the donation. More therefore is involved than mere acceleration of the time of enjoyment. The very right of enjoyment is affected, the difference dependent upon the grantor's power being between present substantial benefit and the mere prospect or possibility, even the probability, that one may have it at some uncertain future time or perhaps not at all. A donor who keeps so strong a hold over the actual and immediate enjoyment of what he put beyond his own power to retake has not divested himself of that degree of control which [§2038] requires in order to avoid the tax. [326 U.S. at 486-487.]

The Court also held that the trusts, which were created before 1936, were embraced by §2038(a)(2), even though that subsection does not include the term "terminate," which is found in §2038(a)(1); the addition of this term in 1936, the Court held, was intended by Congress as declaratory, rather than to change existing law.

LOBER v. UNITED STATES

346 U.S. 335 (1953)

Mr. Justice Black delivered the opinion of the Court.

This is an action for an estate tax refund brought by the executors of the estate of Morris Lober. In 1924 he signed an instrument conveying to himself as trustee money and stocks for the benefit of his young son. In 1929 he executed two other instruments, one, for the benefit of a daughter, the other for a second son. The terms of these three instruments were the same. Lober was to handle the funds, invest and reinvest them as he deemed proper. He could accumulate and reinvest the income with the same freedom until his children reached twenty-one years of age. When twenty-one they were to be paid the accumulated income. Lober could hold the principal of each trust until the beneficiary reached twenty-five. In case he died his wife was to be trustee with the same broad powers Lober had conveyed to himself. The trusts were declared to be irrevocable, and as the

case reaches us we may assume that the trust instruments gave Lober's children a "vested interest" under state law, so that if they had died after creation of the trusts their interests would have passed to their estates. A crucial term of the trust instruments was that Lober could at any time he saw fit turn all or any part of the principal of the trusts over to his children. Thus he could at will reduce the principal or pay it all to the beneficiaries, thereby terminating any trusteeship over it.

Lober died in 1942. By that time the trust property was valued at more than $125,000. The Internal Revenue Commissioner treated this as Lober's property and included it in his gross estate. That inclusion brought this lawsuit. The Commissioner relied on [§2038]. That section, so far as material here, required inclusion in a decedent's gross estate of the value of all property that the decedent had previously transferred by trust "where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power . . . to alter, amend, or revoke. . . ." In Commissioner v. Holmes, 326 U.S. 480, we held that power to terminate was the equivalent of power to "alter, amend, or revoke" it, and we approved taxation of the Holmes estate on that basis. Relying on the *Holmes* case, the Court of Claims upheld inclusion of these trust properties in Lober's estate. 124 Ct. Cl. 44, 108 F. Supp. 731. This was done despite the assumption that the trust conveyances gave the Lober children an indefeasible "vested interest" in the properties conveyed. The Fifth Circuit Court of Appeals had reached a contrary result where the circumstances were substantially the same, in Hays' Estate v. Commissioner, 181 F.2d 169, 172-174. Because of this conflict, we granted certiorari. 345 U.S. 969.

Petitioners stress a factual difference between this and the *Holmes* case. The *Holmes* trust instrument provided that if a beneficiary died before expiration of the trust his children succeeded to his interest, but if he died without children, his interest would pass to his brothers or their children. Thus the trustee had power to eliminate a contingency that might have prevented passage of a beneficiary's interest to his heirs. Here we assume that upon death of the Lober beneficiaries their part in the trust estate would, under New York law, pass to their heirs. But we cannot agree that this difference should change the *Holmes* result.

We pointed out in the *Holmes* case that [§2038] was more concerned with "present economic benefit" than with "technical vesting of title or estates." And the Lober beneficiaries, like the Holmes beneficiaries, were granted no "present right to immediate enjoyment of either income or principal." The trust instrument here gave none of Lober's children full "enjoyment" of the trust property, whether it "vested" in them or not. To get this full enjoyment they had to wait until they reached the age of twenty-five unless their father sooner gave them the money and stocks by terminating the trust under the power of change he kept to the very date of his death. This father could have given property to his children without reserving in himself any power to change the terms as to the date his gift would be wholly effective, but he did not. What we said in the *Holmes* case fits this situation too: "A donor who keeps so strong a hold over the actual and immediate enjoyment of what he puts beyond his own power to retake has not divested himself of that degree of control which [§2038] requires in order to avoid the tax." Commissioner v. Holmes, supra, at 487.

Affirmed.

MR. JUSTICE DOUGLAS and MR. JUSTICE JACKSON dissent.

COMMISSIONER v. HAGER'S ESTATE

173 F.2d 613 (3d Cir. 1949)

Before GOODRICH, MCLAUGHLIN and KALODNER, Circuit Judges.

GOODRICH, Circuit Judge.

This case involves the liability of the estate of William M. Hager for asserted estate taxes under [§2038(a)(2)]. The Tax Court decided in favor of the taxpayer and the Commissioner's appeal has asked reversal. . . .

The question which we must decide is whether under the provisions of the trusts presently to be described the enjoyment was subject to change at the date of the grantor's death "through the exercise of a power . . . to alter, amend or revoke. . . ." If it was, the Tax Court was wrong and the Commissioner is entitled to the tax claimed.

The five trusts in question were set up in 1924. The decedent and his wife each contributed one half of the original corpus in certain shares of corporate stock. The children and grandchildren named as beneficiaries were given life estates together with powers to appoint the remainders by will. There were gifts over in default of appointment. The trusts were irrevocable and the trustee retained no power to terminate them prior to the designated period for their expiration, which was the death of the grantor's son.

The decedent was named trustee under all the trusts, and they were administered as a unit. He retained very wide powers, it quite evidently being the intention to set up the type of trust in which he hoped by the exercise of business judgment to enlarge the trust estate for members of his family. In particular, he was authorized, by paragraph 5 of each trust indenture, to determine, as it pleased him, whether gains realized from the sale of securities in the trusts should be treated as income or retained as part of the corpus.[1] By paragraph 8 he could pay out or accumulate income at his sole discretion, and could treat the accumulations as corpus or income.[2] The Commissioner relies upon these paragraphs to show that the decedent, when he died, had in his hands the power to alter or amend.

The corpus of the estate increased in value and at the time of the decedent's death was considerably greater in dollar value than it was on the date created. The Commissioner, by stipulation, is claiming only half of the total value of the trusts. In other words, he is not claiming estate tax on the portion contributed to the trusts by Mrs. Hager, the decedent's wife, and the increment on that portion.

Except in one particular, Commissioner v. Holmes' Estate [supra p. 1145] is pre-

[1] "(5) As between the beneficiary of this trust and those entitled to the remainder hereunder, any increment, however accruing, to the value of any investment constituting a part of the principal of the trust shall be for the benefit of those entitled to the remainder except that if any such security, to the value of which there shall be any increment, by way of increase of market price or otherwise, shall be sold or otherwise disposed of during the period of the trust, such increment, in the discretion of the Trustee, may be either treated as income to be disposed of in accordance with the terms hereof, or be retained as a part of the corpus of the trust."

[2] "(8) The Trustee may from time to time pay over to our said son, or expend for his benefit, so much of the income from the trust estate as in the sole judgment of the Trustee it shall be advisable so to do. So much of such income as shall not be so paid or expended shall be accumulated as a part of the trust estate, but at any time and from time to time after there has been any such accumulation of income, the Trustee may either pay the whole or any part thereof to our said son or expend it for his benefit — it being the intent that the income from the trust estate not actually paid over to or expended for the benefit of our said son shall not become irrevocably a part of the corpus of such estate, but may thereafter at any time, and from time to time, be by the Trustee either paid over to him or expended for his benefit. . . ."

cisely in point. The difference between that case and this one is that in the *Holmes* trust the settlor had the power to terminate the trust before the date stipulated for expiration. The court's problem was to determine whether the power to "terminate" was a power to "alter or amend." It was held to be so in language which we think is pretty strongly persuasive in our situation here. The court said:

> It seems obvious that one who has the power to terminate contingencies upon which the right of enjoyment is staked, so as to make certain that a beneficiary will have it who may never come into it if the power is not exercised, has power which affects not only the time of enjoyment but also the person or persons who may enjoy the donation.

In this case our question is whether the power which the settlor retained is enough to be called the power to "alter or amend." He could allocate gains to income, so the life tenants would get them, or to corpus, so that the remaindermen would get them. This we think is a very substantial power. So, too, is the power to determine whether or not the life tenants are to get anything at all. It is, of course, well settled that the power to alter or amend does not have to extend to everybody in the world. It is sufficient if the power to allocate exists as among those named as beneficiaries or possible beneficiaries of a trust. We think there is no doubt, therefore, that as to the increase in value of the trusts at the date of the settlor's death, he had the power to alter or amend as to (1) the increments to corpus which had come by the profitable buying and selling of securities, and (2) income of the life tenant which the settlor-trustee could withhold or pay over at his discretion.

Is the taxable interest limited to that just stated or does it include the one half the value of the total estates, as the Commissioner claims? This question the court did not have in the *Holmes* case. There the power to alter or amend by terminating the trust certainly cut across the entire corpus. That is not quite this case. Here the trustee, as explained above, could withhold income from a life tenant, reassign it to corpus and then assign it out again. He could allocate profits from buying and selling trust securities to either corpus or income. He could buy speculative securities if he chose. He was expressly empowered to exercise in dealing with the trust estates "each and every right that might be exercised by one holding the same as his individual property." But we take it that in spite of this clause he could not wilfully eliminate the interests of the remaindermen.

Our legal question, therefore, is whether such a limitation on the power of a grantor has the effect of limiting the power of the United States to levy its estate tax based on the value of the whole trust. The First Circuit has assumed so in a recent dictum. Industrial Trust Company v. Commissioner [infra p. 1201]. In Commissioner v. Bridgeport City Trust Co., 2 Cir. 1941, 124 F.2d 48, the court upheld a claim by the Commissioner to the inclusion of the income beneficiaries' interest in a trust where a settler had reserved to himself the power to reallocate the disposition of the income. It is to be noted, however, that the Commissioner got, by this holding, all that he had claimed. Therefore, the question whether the value of the entire estate could have been subject to the estate tax was not before the court. . . . Our conclusion is that the grantor of these trusts retained to himself as trustee a sufficient power to alter or amend to affect very substantially the interests of the life tenants and the remaindermen, even though he could not, unless he lost all the money of the trusts by unfortunate investments, completely eliminate the remaindermen. He could certainly affect them by many of the things he kept power in himself to do. We think there is enough retained

to bring the grantor within the wording of the statute and that the Commissioner's contention, therefore, must be upheld.

The decision of the Tax Court will be reversed and the case remanded for further proceedings not inconsistent with this opinion.

NOTE

1. *Basis of Hager's Estate.* Was the decision based on the grantor's power to allocate capital gains between the life tenants and the remaindermen? If so, why was the entire corpus, rather than just the amount of such gains, included?

Was it the grantor's power to make investments that brought the corpus into the gross estate? (The investment clause is not set out in the Tax Court opinion, ¶46,266 P-H Memo T.C.) It has usually been assumed that investment powers, at least if they are of a "normal" character, do not bring a trust into the gross estate. Reinecke v. Northern Trust Co., 278 U.S. 339, 346-347 (1929), is the origin of this assumption, but this case was decided under the general language of the postponed-possession-or-enjoyment clause, rather than under the more specific language of §2038. See Commonwealth Trust Co. v. Driscoll, 50 F. Supp. 649 aff'd, 137 F.2d 653 (3d Cir. 1943), cert. denied, 321 U.S. 764, involving an investment clause that was interpreted to mean that the grantor could withdraw any securities from the trust and substitute worthless ones in their place; the court found the clause, as thus construed, to be tantamount to a power to revoke.

For more on the effect of broad powers of administration, when retained by the settlor, see page 1193 infra.

In Whitworth's Estate v. Commissioner, ¶63,041 P-H Memo T.C. (1963), the Internal Revenue Service argued that the value of a widow's right to receive a pension under an employment contract between her deceased husband and his employer was includible in his gross estate under §2038 because until the date of his death he could have cut off her rights expectancy by ceasing to work or breaching the contract. Is this a valid construction of §2038?

2. *Amount includible under §2038.* The final point in *Hager's Estate* — the amount to be included in the gross estate — will be considered again infra page 1208.

3. *Transfers to minors under custodian acts.* What is the estate tax status of property transferred by the donor to himself as custodian for a minor under the recently enacted custodian acts, described in Rev. Rul. 56-484, supra page 386? See Rev. Rul. 57-366, 1957-2 C.B. 618 (property is includible in gross estate, if donor dies while acting as custodian and before donee reaches age of 21).

4. *Effect of retained power on "enjoyment."* Section 2038(a) speaks of a transfer "where the enjoyment thereof was subject at the date of [the decedent's] death to any change through the exercise of a power to alter, amend, revoke, or terminate." For income tax purposes, §674 provides that certain powers over the beneficiary's enjoyment are not sufficiently weighty to require the grantor to report the trust income. Despite the reservation in *Porter* case (supra p. 1144) of the question "whether every change, however slight or trivial, would be within the meaning of [§2038]," there are many powers that clearly engender estate tax liability even though the income produced by the property was not taxable to the grantor during his lifetime because the power was exempted by §674(b).

5. *Relinquishment of power in contemplation of death.* Section 2038(a) applies to property if the decendent could have changed its beneficial enjoyment through the exercise of a power that he relinquished in contemplation of death within the 3-year period prescribed by §2035(b).

6. *The differences between §2038(a)(1) and §2038(a)(2).* There are three differences between §2038(a)(1) and §2038(a)(2), all apparently prompted by White v. Poor, 296 U.S. 98 (1935), where the decedent possessed a power to terminate a trust. In 1919, the decedent conveyed property in trust to herself, her son, and a third person as trustees, conferring the power to terminate on the trustees; in 1920, she resigned as trustee and was

succeeded by her daughter; and in 1921, the daughter resigned and the decedent was reappointed as a trustee by the two other trustees, with the approval of the beneficiaries. The Court of Appeals held that the power to "terminate" did not constitute a power to "alter, amend or revoke." Without passing on this question, the Supreme Court held that the power that the decedent possessed at the time of her death had been acquired "solely by virtue of the action of the other trustees and the beneficiaries, and not in any sense by virtue of any power reserved to herself as settlor in the original declaration of trust" and that "neither technically nor in substance does the power to terminate as it existed from 1921 to the date of [the decedent's] death fall within" what is now §2038-(a)(2). In 1936, Congress divided the "alter, amend, or revoke" provision into two paragraphs, depending upon whether the transfer occurred before or after June 22, 1936, and made the following changes in the post-1936 paragraph:

(a) The addition of the term "terminate," held to be declaratory in the *Holmes* case, supra page 1145.

(b) The addition of the phrase "(in whatever capacity exercisable)." Although the Supreme Court in the *Holmes* case, supra page 1145, refrained from stating whether this phrase was declaratory of the pre-1936 law or not, the lower courts have held that it was. See Jennings v. Smith, infra page 1155.

(c) The addition of the phrase "(without regard to when or from what source the decedent acquired such power)." This phrase apparently is in part declaratory of the existing law. See Vaccaro v. United States, 149 F.2d 1014 (5th Cir. 1945), and Regs. §20.2038-1(d), as to a power to revoke arising by operation of law.* In other respects, however, the change marks a difference of substance, prospectively overruling White v. Poor, supra. Cutcheon v. Commissioner, 3 T.C. 636 (1944).

ESTATE OF SANFORD v. COMMISSIONER

308 U.S. 39 (1939)

MR. JUSTICE STONE delivered the opinion of the Court.

This and its companion case, Rasquin v. Humphreys, post, p. 54, present the single question of statutory construction whether in the case of an inter vivos transfer of property in trust, by a donor reserving to himself the power to designate new beneficiaries other than himself, the gift becomes complete and subject to the gift tax imposed by the federal revenue laws at the time of the relinquishment of the power. Correlative questions, important only if a negative answer is given to the first one, are whether the gift becomes complete and taxable when the trust is created or, in the case where the donor has reserved a power of revocation for his own benefit and has relinquished it before relinquishing the power to change beneficiaries, whether the gift first becomes complete and taxable at the time of relinquishing the power of revocation.

In 1913, before the enactment of the first gift tax statute of 1924, decedent created a trust of personal property for the benefit of named beneficiaries, reserving to himself the power to terminate the trust in whole or in part, or to modify it. In 1919 he surrendered the power to revoke the trust by an appropriate writing in which he reserved "the right to modify any or all of the trusts" but provided that this right "shall in no way be deemed or construed to include any

* In several states voluntary trusts are revocable by the settlor, unless expressly made irrevocable in the trust instrument. Cal. Civ. Code §2280 (Deering, 1960); Okla. Stat., tit. 60, §175.41 (1951); Tex. Rev. Civ. Stat., art. 7425b-41 (Vernon, 1960). In Louisiana, the Code of 1808 provided that interspousal gifts were always revocable; the provision was repealed in 1942. 9 West's L.S.A. §2171 (1950). See Vaccaro v. United States, 149 F.2d 1014 (5th Cir. 1945); Note, 55 Harv. L. Rev. 684 (1942); Cappa, The Effect of Section 2280 of the California Civil Code on the Federal Estate Tax Liability, 15 So. Calif. L. Rev. 155 (1942). Apart from statute, the grantor may have the power to revoke or rescind because of his incapacity, the beneficiary's fraud, etc.; see 3 Scott, Trusts §§329A and 333 (2d ed., 1956).

right or privilege" in the donor "to withdraw principal or income from any trust." In August, 1924, after the effective date of the gift tax statute, decedent renounced his remaining power to modify the trust. After his death in 1928, the Commissioner following the decision in Hesslein v. Hoey, 91 F.2d 954, in 1937, ruled that the gift became complete and taxable only upon decedent's final renunciation of his power to modify the trusts and gave notice of a tax deficiency accordingly.

The order of the Board of Tax Appeals sustaining the tax was affirmed by the Court of Appeals for the Third Circuit, 103 F.2d 81, which followed the decision of the Court of Appeals for the Second Circuit in Hesslein v. Hoey, supra, in which we had denied certiorari, 302 U.S. 756. In the *Hesslein* case, as in the *Humphreys* case now before us, a gift in trust with the reservation of a power in the donor to alter the disposition of the property in any way not beneficial to himself, was held to be incomplete and not subject to the gift tax under the 1932 Act so long as the donor retained that power.

We granted certiorari in this case, 307 U.S. 618, and in the *Humphreys* case, id. 619, upon the representation of the Government that it has taken inconsistent positions with respect to the question involved in the two cases and that because of this fact and of the doubt of the correctness of the decision in the *Hesslein* case decision of the question by this Court is desirable in order to remove the resultant confusion in the administration of the revenue laws.

It has continued to take these inconsistent positions here, stating that it is unable to determine which construction of the statute will be most advantageous to the Government in point of revenue collected. It argues in this case that the gift did not become complete and taxable until surrender by the donor of his reserved power to designate new beneficiaries of the trusts. In the *Humphreys* case it argues that the gift upon trust with power reserved to the donor, not afterward relinquished, to change the beneficiaries was complete and taxable when the trust was created. It concedes by its brief that "a decision favorable to the government in either case will necessarily preclude a favorable decision in the other."

In ascertaining the correct construction of the statutes taxing gifts, it is necessary to read them in the light of the closely related provisions of the revenue laws taxing transfers at death, as they have been interpreted by our decisions. Section 319 et seq. of the Revenue Act of 1924, 43 Stat. 253, reenacted as §501 et seq. of the 1932 Act, 47 Stat. 169, imposed a graduated tax upon gifts. It supplemented that laid on transfers at death, which had long been a feature of the revenue laws. When the gift tax was enacted Congress was aware that the essence of a transfer is the passage of control over the economic benefits of property rather than any technical changes in its title. . . . The rule was thus established, and has ever since been consistently followed by the Court, that a transfer of property upon trust, with power reserved to the donor either to revoke it and recapture the trust property or to modify its terms so as to designate new beneficiaries other than himself is incomplete, and becomes complete so as to subject the transfer to death taxes only on relinquishment of the power at death.

There is nothing in the language of the statute, and our attention has not been directed to anything in its legislative history to suggest that Congress had any purpose to tax gifts before the donor had fully parted with his interest in the property given, or that the test of the completeness of the taxed gift was to be any different from that to be applied in determining whether the donor has retained an interest such that it becomes subject to the estate tax upon its extinguishment at death. The gift tax was supplementary to the estate tax. The two are in pari materia and must be construed together. Burnet v. Guggenheim [supra p. 1007]. An important, if not the main, purpose of the gift tax was to

prevent or compensate for avoidance of death taxes by taxing the gifts of property inter vivos which, but for the gifts, would be subject in its original or converted form to the tax laid upon transfers at death.[1]

Section [2012] provides that when a [gift] tax has been imposed upon a gift, the value of which is required by any provision of the statute taxing the estate to be included in the gross estate, the gift tax is to be credited on the estate tax. The two taxes are thus not always mutually exclusive, as in the case of gifts made in contemplation of death which are complete and taxable when made, and are also required to be included in the gross estate for purposes of the death tax. But [§2012] is without application unless there is a gift inter vivos which is taxable independently of any requirement that it shall be included in the gross estate. Property transferred in trust subject to a power of control over its disposition reserved to the donor is likewise required by [§2038] to be included in the gross estate. But it does not follow that the transfer in trust is also taxable as a gift. The point was decided in the *Guggenheim* case where it was held that a gift upon trust, with power in the donor to revoke it is not taxable as a gift because the transfer is incomplete and that the transfer whether inter vivos or at death becomes complete and taxable only when the power of control is relinquished. We think, as was pointed out in the *Guggenheim* case, that the gift tax statute does not contemplate two taxes upon gifts not made in contemplation of death, one upon the gift when a trust is created or when the power of revocation, if any, is relinquished, and another on the transfer of the same property at death because the gift previously made was incomplete.

It is plain that the contention of the taxpayer in this case that the gift becomes complete and taxable upon the relinquishment of the donor's power to revoke the trust cannot be sustained unless we are to hold, contrary to the policy of the statute and the reasoning in the *Guggenheim* case, that a second tax will be incurred upon the donor's relinquishment at death of his power to select new beneficiaries, or unless as an alternative we are to abandon our ruling in the *Porter* case [supra p. 1144]. The Government does not suggest, even in its argument in the *Humphreys* case, that we should depart from our earlier rulings, and we think it clear that we should not do so both because we are satisfied with the reasoning upon which they rest and because departure from either would produce inconsistencies in the law as serious and confusing as the inconsistencies in administrative practice from which the Government now seeks relief.

There are other persuasive reasons why the taxpayer's contention cannot be sustained. By [§6324(b)], the donee of any gift is made personally liable for the tax to the extent of the value of the gift if the tax is not paid by the donor. It can hardly be supposed that Congress intended to impose personal liabilities upon the donee of a gift of property, so incomplete that he might be deprived of

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1 The gift tax provisions of the Revenue Act of 1924 were added by amendments to the revenue bill introduced on the floor of the House and the Senate. The sponsor of the amendment in both houses urged the adoption of the bill as a "corollary" or as "supplemental" to the estate tax. Cong. Rec., Vol. 65, Part 3, pp. 3119, 3120, 3122; Part 4, p. 3172; Cong. Rec., Vol. 65, Part 8, pp. 8095, 8096.

The gift tax of 1924 was repealed when Congress, concurrently with the enactment of §302(c) of the Revenue Act of 1926, 44 Stat. 70, 125, 126, establishing a conclusive presumption that gifts within two years of death were made in contemplation of death and therefore subject to the estate tax. A gift tax was reenacted by §501 of the Revenue Act of 1932, 47 Stat. 169, shortly after it was decided in Heiner v. Donnan, 285 U.S. 312, that the legislative enactment of such a presumption violated the Fifth Amendment.

Section 501(c) of the 1932 Act added a new provision that transfers in trust, with power of revocation in the donor, should be taxed on relinquishment of the power. This was repealed by §511 of the Act of 1934, 48 Stat. 680, because Burnet v. Guggenheim, 288 U.S. 280, had declared that such was the law without specific legislation. H.R. No. 704, 73rd Cong., 2d Sess., p. 40; Sen. Rep. No. 558, 73rd Cong., 2d Sess., p. 50.

it by the donor the day after he had paid the tax. Further, [§2522] exempts from the tax, gifts to religious, charitable, and educational corporations and the like. A gift would seem not to be complete, for purposes of the tax, where the donor has reserved the power to determine whether the donees ultimately entitled to receive and enjoy the property are of such a class as to exempt the gift from taxation. Apart from other considerations we should hesitate to accept as correct a construction under which it would plausibly be maintained that a gift in trust for the benefit of charitable corporations is then complete so that the taxing statute becomes operative and the gift escapes the tax even though the donor should later change the beneficiaries to the non-exempt class through exercise of a power to modify the trust in any way not beneficial to himself.

The argument of petitioner that the construction which the Government supports here, but assails in the *Humpreys* case, affords a ready means of evasion of the gift tax is not impressive. It is true, of course, that under it gift taxes will not be imposed on transactions which fall short of being completed gifts. But if for that reason they are not taxed as gifts they remain subject to death taxes assessed at higher rates, and the Government gets its due, which was precisely the end sought by the enactment of the gift tax.

Nor do we think that the provisions of [§676(a), relating to income tax, supra p. 367] have any persuasive influence on the construction of the gift tax provisions with which we are now concerned. One purpose of the gift tax was to prevent or compensate for the loss of surtax upon income where large estates are split up by gifts to numerous donees. Congress was aware that donors in trust might distribute income among several beneficiaries, although the gift remains so incomplete as not to be subject to the tax. It dealt with that contingency in [§676(a)] which taxes to the settlor the income of a trust paid to beneficiaries where he reserved to himself an unexercised power to "revest in himself title" to the trust property producing the income. Whether this section is to be read as relieving the donor of the income tax where the power reserved is to modify the trust, except for his own benefit, we do not now decide. If Congress, in enacting it, undertook to define the extent to which a reserved power of control over the disposition of the income is equivalent to ownership of it so as to mark the line between those cases on the one hand where the income is to be taxed to the donor and those on the other where, by related sections, the income is to be taxed to the trust or its beneficiaries, we do not perceive that the section presents any question so comparable to that now before us as to affect our decision. We are concerned here with a question to which Congress has given no answer in the words of the statute, and it must be decided in conformity to the course of judicial decision applicable to a unified scheme of taxation of gifts whether made inter vivos or at death. If Congress, for purpose of taxing income, has defined precisely the amount of control over the income which it deems equivalent to ownership of it, that definition is controlling on the courts even though without it they might reach a different conclusion, and even though retention of a lesser degree of control be deemed to render a transfer incomplete for the purpose of laying gift and death taxes.

The question remains whether the construction of the statute which we conclude is to be derived from its language and history, should be modified because of the force of treasury regulations or administrative practice. [The Court went on to hold that the Regulations were "ambiguous and without persuasive force in determining the true construction of the statute" and that the administrative practice was too inconsistent to be accepted as an expert interpretation of the statute.]

Affirmed.

MR. JUSTICE BUTLER took no part in the consideration or decision of this case.

NOTE

1. *Implications of Sanford case.* Is a gift tax payable on the creation of a trust of the type involved in Commissioner v. Chase National Bank, supra page 1144? Higgins v. Commissioner, 129 F.2d 237 (1st Cir. 1942), cert. denied, 317 U.S. 658. Of the type involved in Commissioner v. Estate of Holmes, supra page 1145? Regs. §25.2511-2(b), (c), and (d).

2. *Tax-free release of "Sanford trust" powers.* In 1943, the gift tax law was amended to permit the tax-free release of a power like that held by the grantor in the *Sanford* case. This dispensation was available only if the trust was created before January 1, 1939, and the release had to occur before January 1, 1948, unless reasonable cause for delay was established. This opportunity to release "Sanford trust" powers without payment of gift tax is reflected by §2038(c), exempting the grantor from estate tax if he was unable to release his power because of mental disability. See Supplee v. Smith, 242 F.2d 855 (3d Cir. 1957); Paul, Federal Estate and Gift Taxation §17.07A (1946 Supp.).

2. *Where Grantor's Power Is Restricted*

a. BY A REQUIREMENT OF NOTICE OR LAPSE OF TIME

Transferred property is includible under §2038 only if enjoyment "was subject *at the date of* [the decedent's] *death* to any change through the exercise of a power . . . by the decedent." What if the decedent was required to give 12 months' notice of his intention to exercise the power or if the change was to take effect only 12 months after exercise of the power? See §2038(b), explained by the House Committee on Ways and Means (H.R. Rept. No. 704, 73d Cong., 2d Sess., 1939-1 C.B. (Part 2) p. 581):

> However, if the retained right to alter, amend, or revoke could be exercised only after a precedent notice of, say, a year, or if the alteration, amendment, or revocation would become effective only after a lapse of time after A performed the act which gave rise to the alteration, amendment, or revocation, it might be contended that under existing law the property is not includible in the decedent's gross estate. While it is believed that such contention would not be well founded, your committee believes it desirable to clarify the law so that under such circumstances it will be entirely clear that all the property of which the decedent at the date of his death has to all intents and purposes practical, if not technical, ownership, is to be included in his gross estate. This section [§2038(b)] clarifies the existing law [pre-1934] on the subject and expressly provides that, although a notice may be required as a condition precedent to exercising the right to alter, amend, or revoke, nevertheless the full value of the property at the date of the decedent's death must be included in the gross estate, less only the outstanding estate (measured by the period required to elapse between the giving of the notice and the taking effect of any alteration, amendment, or revocation) which at the decedent's death is irrevocably beyond his control.

Does the decedent have a power "at the time of his death" under §2038 if he could not exercise it immediately before his death because of incompetence, perhaps caused by the last illness itself? In Hurd v. Commissioner, 160 F.2d 610, 613 (1st Cir. 1947), a power held by the grantor as trustee was charged against him despite his incapacity, but the court indicated that the result would have been otherwise had he resigned or been removed before death. It also hinted, however, that if a successor fiduciary had been appointed to act for him, he would be considered as still possessing the power at the time of his death.

b. BY A STANDARD OR CONTINGENCY

JENNINGS v. SMITH

161 F.2d 74 (2d Cir. 1947)

Before SWAN, CHASE and FRANK, Circuit Judges.

SWAN, Circuit Judge.

This is an action by the executors of the will of Oliver Gould Jennings, a resident of Connecticut whose death occurred on October 13, 1936, to recover such part of the estate tax paid by them to the defendant collector as had been illegally collected. Their right to a refund of the amount claimed is clear under Maass v. Higgins, 312 U.S. 443, and was not disputed; but the defendant set up in defense an additional estate tax liability (greater than the alleged overpayment) based on the failure to include in the decedent's gross estate the value of certain property which he had transferred in trust in 1934 and 1935. Although assessment of an additional estate tax was barred by the statute of limitations, the plaintiffs do not contend that they are entitled to a refund unless the tax legally due was overpaid. See Lewis v. Reynolds, 284 U.S. 281. Hence the question presented at the trial and renewed here, is whether the value of the trust property should have been included in the gross estate. The district court held it includible under [§2038]. Accordingly judgment was given for the defendant, and the plaintiffs have appealed.

In December 1934 the decedent set up two trusts: one for the family of his elder son, B. Brewster Jennings, the other for the family of his younger son, Lawrence K. Jennings. The trust instruments were identical, except for the names of the beneficiaries and the property transferred. In discussing the terms of the trusts it will suffice to refer to the one set up for the elder son's family. The trust was irrevocable and in so far as legally permissible its provisions were to be interpreted and enforced according to Connecticut law. It reserved no beneficial interest to the settlor. He and his two sons were named as the trustees; in case a vacancy should occur provision was made for the appointment of a successor trustee having like powers; there were always to be three trustees and they were authorized to act by majority vote. At the end of each year during the life of the son, the trustees were to accumulate the net income by adding it to the capital of the trust but they were given power, "in their absolute discretion" at any time during the year and prior to the amalgamation of that year's net income into capital, to use all or any part of it for the benefit of the son or his issue provided "the trustees shall determine that such disbursement is reasonably necessary to enable the beneficiary in question to maintain himself and his family, if any, in comfort and in accordance with the station in life to which he belongs." Upon the death of the son the capital of the trust was to be divided into separate equal trust funds, one for each of his surviving children and one for each deceased child who left issue surviving at the death of the son. The trustees also had power to invade the capital upon the terms set out in paragraph 3(f) of the trust deed. In the Lawrence K. Jennings trust all current net income for the years 1935 and 1936 was paid to him, the trustees, of whom the decedent was one, having unanimously determined that such payments were necessary to enable Lawrence to maintain himself and his family in comfort and in accordance with his station in life. No payment or application of income of the B. Brewster Jennings trust, and none of capital of either trust, was made or requested during the life of the decedent.

Gift tax returns covering the transfers in trust were duly filed and taxes paid thereon. The trusts were not created in contemplation of death, nor to reduce estate taxes on the settlor's estate.

[The court held that a power exercisable in a fiduciary capacity is includible under §2038(a)(2), as under §2038(a)(1), because the addition of the parenthetical clause "in whatever capacity exercisable" in §2038(a)(1) was declaratory of existing law. See Commissioner v. Newbold's Estate, 158 F.2d 694.]

The next question is whether the powers conferred upon the trustees in the case at bar are powers of the character described in [§2038(a)(2)], which requires that enjoyment of the trust property must be subject at the date of the decedent's death to change through the exercise of a power. The trustees' power to invade the capital of the trust property was exercisable only if the son or his issue "should suffer prolonged illness or be overtaken by financial misfortune which the trustees deem extraordinary." Neither of these contingencies had occurred before the decedent's death; hence enjoyment of the capital was not "subject at the date of his death to any change through the exercise of a power." In Commissioner v. Flanders, 2 Cir., 111 F.2d 117, although decision was rested on another ground, this court expressed the opinion that a power conditioned upon an event which had not occurred before the settlor's death was not within the section. In support of this view we cited Tait v. Safe Deposit & Trust Co., 4 Cir., 74 F.2d 851, 858; Day v. Commissioner, 3 Cir., 92 F.2d 179; Patterson v. Commissioner, 36 B.T.A. 407. The question has recently been explored by the Tax Court in Estate of Budlong v. Commissioner, 7 T.C. 758.* There it was held in a convincing opinion that the power of trustees to invade corpus in case of "sickness or other emergency," which had not occurred before the decedent's death, was not a power to "alter, amend or revoke" within the meaning of the statute. The court reasoned that the trustees had not unlimited discretion to act or withhold action under the power, since the trust instrument provided an external standard which a court of equity would apply to compel compliance by the trustees on the happening of the specified contingency or to restrain threatened action if the condition were not fulfilled. In the case at bar the district judge was of opinion that even if the trustees found that the stated conditions had been fulfilled, "their finding created no enforcible rights in any of the beneficiaries." 63 F. Supp. at 837. In this view we are unable to concur. The condition upon which the power to invade capital might arise is sufficiently definite to be capable of determination by a court of equity. As Judge L. Hand said in Stix v. Commissioner, 2 Cir., 152 F.2d 562, 563, "no language, however strong, will entirely remove any power held in trust from the reach of a court of equity." . . . Since the trustees were not free to exercise untrammeled discretion but were to be governed by determinable standards, their power to invade capital, conditioned on contingencies which had not happened, did not in our opinion bring the trust property within the reach of [§2038(a)(2)].

Similar reasoning leads to the same conclusion with respect to the trustees' power over net income. At the end of each calendar year they were to accumulate the net income of that year unless prior to its amalgamation into capital they exercised their power to disburse it to, or for the benefit of, the son or his issue. The power the trustees had with respect to disbursing income was exercisable year by year; and at the date of the decedent's death the only income of which the enjoyment was subject to change through exercise of a power was the income of the B. Brewster Jennings trust for the year 1936. But the exercise of this

* Aff'd in part, rev'd in part, sub nom. Industrial Trust Co. v. Commissioner, infra page 1201. — Ed.

power was conditioned on the trustees' determination that disbursement of the income was necessary to enable the beneficiary to whom it might be allotted to maintain himself and his family "in comfort and in accordance with the station in life to which he belongs." The contingency which would justify exercise of the power had not happened before the decedent's death; consequently the 1936 net income of the B. Brewster Jennings trust was not subject at the date of the decedent's death "to any change through the exercise of a power." Hence it was not includible in the gross estate of the decedent under [§2038(a)(2)]. This conclusion is not inconsistent with Commissioner v. Newbold's Estate, 2 Cir., 158 F.2d 694, for there the trustees had unlimited discretion, the trust instrument expressly providing that no beneficiary should have any vested right to receive any payment from income. . . .

The judgment is reversed and the cause remanded with directions to enter judgment for the plaintiffs.

NOTE

1. *Contingent powers under §2038.* With the court's statement that a contingent power is not within the reach of §2038 if the contingency has not occurred before the decedent's death, see Regs. §20.2038-1(b), stating that "section 2038 is not applicable to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death (e.g., the death of another person during the decedent's life)." Before 1954, however, the Regulations took the position that a power to alter, amend, or revoke "will be considered to have existed on the date of the decedent's death . . . though the exercise of the power was restricted to a particular time which had not arrived or the happening of a particular event which had not occurred, at decedent's death." See In re Field's Estate, 143 F. Supp. 520 (S.D.N.Y. 1956).

What is the status of a power dependent on a contingency over which the grantor has some control — e.g., his marriage or divorce?

If the beneficiary in Jennings v. Smith had suffered a prolonged illness or a financial misfortune during the decedent's life, would part or all of the corpus of the trust have been includible in the gross estate?

2. *The "enforceable external standard."* How restricted was the discretion of the trustees in Jennings v. Smith? See Estate of Wilson v. Commissioner, 13 T.C. 869 (1949), aff'd per curiam, 187 F.2d 145 (3d Cir. 1951), holding that the following clause embodied an "adequate external standard" to govern the discretion of the trustee: "The Trustee may in its absolute discretion accelerate payments of interest or principal in case of need for educational purposes or because of illness or for any other good reason." See also Estate of Wier v. Commissioner, 17 T.C. 409, 418-420 (1951), holding that the following clause was sheltered by Jennings v. Smith: ". . . the Trustees [the decedent and his brother] shall expend from time to time as they may deem necessary or proper for the support, maintenance and education of [the decedent's daughter] such sum or sums as such Trustees shall in their sole discretion consider to the interest and advantage of [the beneficiary]. . . . [The beneficiary] shall be properly maintained, educated and supported in the manner appropriate to her station in life, and if, in the discretion and judgment of the said Trustees, it be necessary to that end, at any time or times, to use all of the income or even all of the corpus of the trust estate hereby created and all augmentations thereof, it shall be the duty of the Trustees to see that [the beneficiary] shall be properly maintained, educated and supported." (It was apparently not contemplated that any of the income or corpus would be so distributed, because the beneficiary was otherwise adequately provided for, but the Tax Court did not rest on this ground.)

A contrary result was reached in Hurd v. Commissioner, 160 F.2d 610 (1st Cir. 1947), where the trustees could pay over the corpus of a trust to the decedent-grantor's wife "if in their opinion the circumstances so require." The court said:

> The word "circumstances," as used in the trust instrument, is as wide as the world and to say that it imposes a legal limitation, or imports a controlling contingency, is

> to stretch it far beyond good sense. We entertain grave doubts that any equity court would harken to the complaints of a disaffected cestui who might interpose objections to the decedent's invasion of the principal for the use of his wife, irrespective of the "circumstances." The clause is not restricted to "her" circumstances, but rather to "the" circumstances. It is difficult to think of a much broader reservation of powers. . . . [160 F.2d at 612-613.]

See also Estate of Yawkey v. Commissioner, infra page 1206, holding that a power to be exercised "in the best interest of the beneficiary" is not protected by Jennings v. Smith; United States v. Powell, 307 F.2d 821 (10th Cir. 1962) (invasion permitted for "maintenance, welfare, comfort or happiness" of beneficiaries; held, an enforceable standard); Michigan Trust Co. v. Kavanaugh, 284 F.2d 502 (6th Cir. 1960) (power to terminate "should what the Trustee deems a special emergency arise"; held, taxable); Regs. §1.674(b)-1(b)(5) ("reasonably definite standard" in income tax context).

In Theopold v. United States, 164 F.2d 404 (1st Cir. 1947), the court said of a power retained by the settlor of a trust "to amend this trust instrument so that it will more clearly express my actual intentions if I shall consider such amendment advisable, as to which I shall be the sole judge":

> . . . the reserved power as we construe it, while a power to amend in the sense of altering language so as more clearly to express an original intention, is not a power to amend in the sense of altering language to express a new or different intention. And so construed we consider it, if in the statutory sense a power to amend at all, to be a power to make only "slight" or "trivial" changes in the trust instrument and hence not a power within the meaning of the taxing statute. [164 F.2d at 407.]

3. *Decedent as beneficiary of contingent power.* If the decedent possessed a power that could be exercised in his own favor upon the occurrence of a contingency (e.g., a power to retake the corpus in the event of prolonged illness or financial misfortune), does the doctrine of Jennings v. Smith apply? See page 1164 infra.

4. *Reference.* Pedrick, The Artful Dodger Faces Life and Looks at Death, 28 Taxes 1151 (1950).

C. BY A REQUIREMENT THAT OTHERS JOIN IN GRANTOR'S ACTION

HELVERING v. CITY BANK FARMERS TRUST CO.

296 U.S. 85 (1935)

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The questions for decision are whether [§2038(a)(2)] requires inclusion in the gross estate of the value of the corpus of a trust established in 1930 where the creator reserved a power to revoke or modify, to be exercised jointly with a beneficiary and the trustee; and whether, if such value is to be included in the gross estate, the section offends the Fifth Amendment. . . .

The Circuit Court of Appeals thought our decision in Reinecke v. Northern Trust Co., 278 U.S. 339, required the language of the Act to be construed as tantamount to "in conjunction with any person not a beneficiary." So limited it is inapplicable to the trust in question.

The *Reinecke* case involved §402(c) of the Revenue Act of 1921, which directed the inclusion in the gross estate of all property "To the extent of any interest therein of which the decedent has at any time made a transfer, or with respect to which he has at any time created a trust, in contemplation of or intended to take effect in possession or enjoyment at or after his death. . . ." It was held that a gift beyond the power of the grantor to alter, amend or revoke could not be said to take effect in possession or enjoyment at or after his death. Con-

versely, one which he alone held the power to revoke or modify came within the section, since, at his death, substantial interests passed from his control and were for the first time confirmed in others. The case involved nothing more than a determination whether the transfers were complete when made. If they were the statute did not reach them.* Here we have a different problem, for [§2038(a)(2)] on its face embraces Mrs. James' transfer, although complete when made and thereafter beyond her own unfettered control.

The respondent says that the section ought to be construed in the light of the analogous §219(g) [1921 Act]. The latter, part of the income tax title, is "Where the grantor of a trust has, at any time during the taxable year, either alone or in conjunction with any person not a beneficiary of the trust, the power to revest in himself title to any part of the corpus of the trust, then the income of such part of the trust for such taxable year shall be included in computing the net income of the grantor." † The two sections have a cognate purpose but they exhibit marked differences of substance. The one speaks of a power to be exercised with one not a beneficiary; the other of a power to be exercised with any person. The one refers to a power to revest the corpus in the donor; the other has no such limitation. It is true, the Report of the Ways and Means Committee on [§2038] said: "this provision is in accord with the principle of [§676(a)] of the bill which taxes to the grantor the income of a revocable trust." But to credit the assertion that the difference in phraseology is without significance and in both sections Congress meant to express the same thought, would be to disregard the clear intent of the phrase "any person" employed in [§2038]. We are not at liberty to construe language so plain as to need no construction, or to refer to Committee reports where there can be no doubt of the meaning of the words used. The section applies to this transfer.

We are next told that if the Act means what it says it taxes a transfer as one taking effect at death though made prior to death and complete when made; that to do this is arbitrary and deprives the taxpayer of property without due process.

The section was first introduced into the Revenue Act of 1924, and reenacted in that of 1926. Mrs. James created her trust in 1930. She was, therefore, upon notice of the law's command, and there can be no claim that the statute is retroactive in its application to her transfer.

The inquiry is whether it is arbitrary and unreasonable to prescribe for the future that, as respects the estate tax, a transfer, complete when made, shall be deemed complete only at the transferor's death, if he reserves power to revoke or alter exercisable jointly with another.

The respondent insists that a power to recall an absolute and complete gift only with the consent of the donee is in truth no power at all; that in such case the so-called exercise of the power is equivalent to a new gift from the donee to the donor. And so it is claimed that the statute arbitrarily declares that to exist

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* Reinecke v. Northern Trust Co. was decided under the Revenue Act of 1921, which reached transfers only if they were in contemplation of death or "intended to take effect in possession or enjoyment" at or after the transferor's death. The Court held that two trusts revocable by the grantor alone came within this language, but that five other trusts whose revocation required the consent of the beneficiaries were not reached by the statute. As to these five trusts, the Court said: "Since the power to revoke or alter was dependent on the consent of the one entitled to the beneficial and consequently adverse, interest, the trust, for all practical purposes, had passed as completely from any control by decedent which might inure to his own benefit as if the gift had been absolute." See Regs. §20.2038-1(e). Since 1924, however, the statute has expressly reached transfers if enjoyment was subject to a power to alter, amend, or revoke, exercisable by the decedent alone or in conjunction with any person. — Ed.

† The current equivalent of this provision is §676(a), supra page 370, which taxes the grantor on the trust income if he or a "non-adverse party" has power to revest title in the grantor. — Ed.

which in fact and law is nonexistent. The position is untenable. The purpose of Congress in adding [§2038] to the section as it stood in an earlier act was to prevent avoidance of the tax by the device of joining with the grantor in the exercise of the power of revocation someone who he believed would comply with his wishes. Congress may well have thought that a beneficiary who was of the grantor's immediate family might be amenable to persuasion or be induced to consent to a revocation in consideration of other expected benefits from the grantor's estate. Congress may adopt a measure reasonably calculated to prevent avoidance of a tax. The test of validity in respect of due process of law is whether the means adopted are appropriate to the end. A legislative declaration that a status of the taxpayer's creation shall, in the application of the tax, be deemed the equivalent of another status falling normally within the scope of the taxing power, if reasonably requisite to prevent evasion, does not take property without due process. But if the means are unnecessary or inappropriate to the proposed end, are unreasonably harsh or oppressive, when viewed in the light of the expected benefit, or arbitrarily ignore recognized rights to enjoy or to convey individual property, the guarantee of due process is infringed.

Illustrations are not lacking of cases falling on either side of the line.

Congress may require that property transferred in contemplation of death, although the transfer is so remote in time as not to comply with the requirements of a gift causa mortis, shall nevertheless be treated as part of the estate for purposes of taxation: this for the prevention of evasion and the giving of practical effect to the exercise of admitted power. This is true despite the fact that the statutory prescription embraces gifts inter vivos which are in fact fully executed, irrevocable and cannot be defeated.

Although property received by gift from another is capital in the hands of the donee, the gain upon a sale may be measured by the cost to the donor rather than the value at the time of acquisition by the donee.

It is competent for Congress, in order to avoid the evasion of tax, to declare that when one has placed his property in trust subject to a right of revocation in himself and another who is not the beneficiary he shall, nevertheless, be deemed to control the property in such sense that the income therefrom shall be treated as his income for the levying of a tax. So also where an irrevocable trust is established to pay for insurance on the settlor's life, to collect the policy upon his death, and to hold or apply the proceeds for the benefit of his dependents, Congress may declare the income of the trust fund taxable to the settlor as part of his own income.

In the instances cited the power to levy an excise upon the testamentary transfers or to tax income was conceded. To effectuate the exercise of this admitted power and to prevent evasion Congress was held to have acted reasonably in including within the sweep of the statute a status or an act not normally within its reach.

There are, however, limits to the power of Congress to create a fictitious status under the guise of supposed necessity. Thus it has been held that an act creating a conclusive presumption that a gift made within two years prior to death was made by the donor in contemplation of death, and requiring the value of the gift to be included in computing the estate of the decedent subject to transfer tax, is so grossly unreasonable as to violate the due process clause of the Fifth Amendment. In the same category falls a statute seeking to tax the separate income of a wife as income of her husband.

In view of the evident purpose of Congress we find nothing unreasonable or arbitrary in the provisions of [§2038] as applied in the circumstances of this case. It was appropriate for Congress to prescribe that if, subsequently to the passage

of that Act, the creator of a trust estate saw fit to reserve to himself jointly with any other person the power of revocation or alteration, the transaction should be deemed to be testamentary in character, that is, treated for the purposes of the law as intended to take effect in possession or enjoyment at the death of the settlor.

The judgment is reversed.

MR. JUSTICE VAN DEVANTER, MR. JUSTICE MCREYNOLDS, MR. JUSTICE SUTHERLAND and MR. JUSTICE BUTLER are of opinion that the judgment should be affirmed.

HELVERING v. HELMHOLZ

296 U.S. 93 (1935)

MR. JUSTICE ROBERTS delivered the opinion of the Court.

This case, like Helvering v. City Bank &c. Tr. Co., ante, p. 85, arises under [§2038(a)(2)]. The respondent is administrator and sole beneficiary of the estate of his wife, Irene C. Helmholz. In 1918 she, her father and mother and her brothers and sisters joined in an indenture conveying to a trustee all of the shares of stock in the Patrick Cudahy Family Company. Her contribution was 999 shares, the dividends from which the trustee was to receive, and pay, less expenses, to Mrs. Helmholz for life, remainder to her appointee by will and remainder to her issue; and in event she or any other subscriber should die without issue the net dividends on the stock delivered to the trustee by such decedent were to be paid "to the surviving subscribers or their issue living at the time of distribution proportionately by right of representation."

The paragraph of the indenture relative to the termination of the trust is:

> Fifth: The term of the primary trust hereby created shall end (1) upon the death of the last surviving grandchild of Patrick and Anna M. Cudahy, they being then deceased, or (2) upon delivery to the said trustee of a written instrument signed by all of the beneficiaries, other than testamentary appointees, declaring said trust term at an end, or (3) upon delivery to said trustee of a copy (certified by the president or secretary of the Patrick Cudahy Family Company and under its corporate seal) of a resolution adopted by unanimous vote of the board of directors of said corporation declaring said trust term at an end, whereupon and in either of said events the said trustee shall distribute the capital stock of the said Patrick Cudahy Family Company to the beneficiaries then entitled to receive the net dividends thereof other than testamentary appointees; excepting the shares to the dividends upon which such testamentary appointees are entitled, which shall be held by said trustee as hereinbefore provided.
>
> The term of the primary trust hereby created shall also terminate upon the dissolution of the said Patrick Cudahy Family Company in the manner and for any of the causes provided by law, whereupon the trustee shall distribute all the proceeds and assets by it received upon the liquidation of said corporation to the beneficiaries other than testamentary appointees then entitled to receive net dividends or income in the proportion in which they are severally entitled, excepting the proceeds and (or) assets of shares to the net dividends or income upon which testamentary appointees are entitled, which shall continue to be held in trust as hereinbefore provided.
>
> The term of the primary trust hereby created shall also terminate upon the extinction of issue of the said Patrick and Anna M. Cudahy, they being then deceased, whereupon the said trustee shall convey and transfer the stock of the said Patrick Cudahy Family Company to the Wisconsin Trust Company as trustee, to have and to hold the same upon the trusts and for the uses and purposes embraced in a certain resolution or declaration of trust adopted by the board of directors of the Wisconsin Trust Company May 24, 1915, establishing a certain community trust known as the Milwaukee Foundation for administration and distribution as in said trust declaration prescribed and defined, subject, however, to any existing valid testamentary appointments made by subscribers hereto as hereinbefore provided.

Irene C. Helmholz left a will bequeathing all her property to respondent. The Supreme Court of Wisconsin held this a valid exercise of her power of appointment under the trust deed. [First Wisconsin Trust Co. v. Helmholz, 198 Wis. 573, 225 N.W. 191.] The petitioner determined that the value of the 999 shares should be included in her gross estate. The Board of Tax Appeals reversed this determination. The United States Court of Appeals for the District of Columbia, to which an appeal was taken pursuant to stipulation for hearing by that court, affirmed the Board. We granted certiorari.

What is said in Helvering v. City Bank & Tr. Co., supra, shows that the transfer was complete when the trust was created in 1918. The features which differentiate this case are the absence of a reserved power of revocation or alteration and the retroactive operation of the Act. Either requires a decision that the corpus of the trust may not be included in the gross estate.

The words of [§2038(a)(2)] are, "where the enjoyment [of the transfer] was subject at the date of his death to any change *through the exercise of a power,* either by the decedent alone or in conjunction with any person, *to alter, amend or revoke. . . .*" The agreement under consideration contains no such power as that described. Like every well drawn instrument it embodies provisions for the termination of the trust. An examination of paragraph Fifth shows that these were, in the main, such as any farsighted settlor would employ. Since the beneficiaries were the issue of Patrick and Anna Cudahy it was natural to provide that upon the extinction of issue the trust should terminate and the principal be turned over to a secondary charitable trust. Inasmuch as the corpus comprised only the shares of a corporation there was nothing out of the ordinary in requiring that the trust terminate upon dissolution of the company and that the proceeds of liquidation be distributed amongst the then beneficiaries. It was not unnatural to direct that the trust should end if the managers of the company should unanimously so decide. And termination upon the death of the last surviving grandchild of Patrick and Anna Cudahy, they being then deceased, is certainly not unusual.

The petitioner, however, pitches upon the only remaining event of termination, asserting it to be the equivalent of a power to revoke, or to amend, to be exercised by the settlor with others. This is found in the clause providing that the delivery to the trustee of a writing signed by all the then beneficiaries (other than testamentary appointees) declaring such purpose, shall be effective to end the trust. He points out that such a writing might have been executed by Mrs. Helmholz and her co-beneficiaries while she was alive, with the effect of revesting in her the shares which she had delivered into the trust. This argument overlooks the essential difference between a power to revoke, alter or amend, and a condition which the law imposes. The general rule is that all parties in interest may terminate the trust. The clause in question added nothing to the rights which the law conferred. Congress cannot tax as a transfer intended to take effect in possession or enjoyment at the death of the settlor a trust created in a state whose law permits all the beneficiaries to terminate the trust.

Another and more serious objection to the application of [§2038(a)(1)] in the present instance is its retroactive operation. The transfer was complete at the time of the creation of the trust. There remained no interest in the grantor. She reserved no power in herself alone to revoke, to alter or to amend. Under the revenue act then in force the transfer was not taxable as intended to take effect in possession or in enjoyment at her death. Reinecke v. Northern Trust Co. [supra p. 1143]. If [§2038(a)(2), enacted in 1926] could fairly be considered as intended to apply in the instant case its operation would violate the Fifth Amendment. Nichols v. Coolidge, 274 U.S. 531.

The judgment is affirmed.

MR. JUSTICE BRANDEIS, MR. JUSTICE STONE and MR. JUSTICE CARDOZO concur in the result on the ground last stated in the opinion.

NOTE

1. *Power vested in all beneficiaries jointly.* Termination of the Helmholz trust could be accomplished by the living beneficiaries, despite the possibility that persons yet unborn (after-born grandchildren) would become beneficiaries. Although this is the law of New York (Smith v. Title Guarantee & Trust Co., 287 N.Y. 500, 41 N.E.2d 72 (1942), interpreting §23 of the N.Y. Personal Property Law), it is not ordinarily possible to cut off the rights of unborn or unascertained beneficiaries — unless the trust instrument so provides. 3 Scott, The Law of Trusts (2d ed. 1956) §340. Cf. Lowndes, Federal Taxation of North Carolina Trusts for Unborn and Unascertained Beneficiaries, 20 N.C.L. Rev. 278 (1942), which was followed by an amendment of the North Carolina law, with Estate of Coulter v. Commissioner, 7 T.C. 1280 (1946), and Estate of Seltzer v. Commissioner, 10 T.C. 810 (1948).

See Regs. §20.2038-1(a)(2), stating that a power does not count under §2038 if it "could be exercised only with the consent of all parties having an interest (vested or contingent) in the transferred property, and if the power adds nothing to the rights of the parties under local law." Does this mean the same as "all the persons beneficially interested" as used in §23 of the N.Y. Personal Property Law, namely, "all *living* persons beneficially interested"?

2. *Power exercisable by third person.* Because §2038 speaks of a power exercisable "by the decedent alone or by the decedent in conjunction with any other person," a power vested in a third person alone is not charged against the grantor by §2038. In determining whether the income of a trust is taxable to the grantor, however, a power vested in a "non-adverse party" is ordinarily treated as though it were held by the grantor himself. §§674-677; supra page 370. There are some exceptions: §674(c) and (d); §675(3). Is there any reason why powers held by a non-adverse person should ordinarily be imputed to the grantor for income tax purposes, but not under the estate tax?

Could a third person be treated as the decedent's alter ego under §2038? See Delaney v. Gardner, 204 F.2d 855 (1st Cir. 1953) (property transferred to non-stock membership corporation; held, not decedent's instrumentality); Kneeland v. Commissioner, 34 B.T.A. 816 (1936) (power to revoke vested in decedent's wife; held, trust not within §2038).

3. *Decedent's power to remove trustee in whom power is vested.* If a power to revoke, amend, etc. was vested in a trustee who could be removed at will by the decedent, and the decedent could have appointed himself as successor trustee, the property is includible under §2038. Regs. §20.2038-1(a)(3); Van Beuren v. McLoughlin, 262 F.2d 315 (1st Cir. 1958). But if the decedent could have named himself only if the trustee had voluntarily resigned, it has been held that §2038 is inapplicable unless the event occurred. United States v. Winchell, 289 F.2d 212 (9th Cir. 1961). What if the decedent retained the unfettered power to remove trustees, but not the right to take over the office himself?

4. *Power to initiate or veto action by third person.* In Thorp's Estate v. Commissioner, 164 F.2d 966 (3d Cir. 1947), cert. denied, 333 U.S. 843 (1948), the corpus of a trust was held to be includible under §2038 because it could be terminated on request by the beneficiaries, provided the decedent consented to such action: "regardless of who could set in motion the termination machinery, the trust could be terminated only by the action of the decedent in conjunction with others." A similar case is Du Charme's Estate v. Commissioner, 164 F.2d 959 (6th Cir. 1947). Does such a veto power come within the "contingency" exception of Regs. §20.2038-1(b) (§2038 not applicable "to a power the exercise of which was subject to a contingency beyond the decedent's control which did not occur before his death")? In Kasch's Estate v. Commissioner, 30 T.C. 102 (1958), the trustees were empowered to invade corpus for "the proper care, support and medical attention" of the beneficiaries, provided the decedent consented. The court held that his power was "contingent" within the meaning of Jennings v. Smith (supra p. 1155). Assuming that the trust instrument permitted the trustees to invade corpus

only under an enforceable external standard, but the decedent's power to veto their decision was wholly discretionary, should the corpus have been included in his estate under §2038?

In United States v. Winchell, 289 F.2d 212 (9th Cir. 1961), the decedent had created an inter vivos trust, reserving the right to confer "additional powers" on the trustee. On the ground that this right was equivalent to a power to alter, amend, or revoke under §2038, the government asserted that the corpus was includible in the decedent's gross estate. The District Court held (180 F. Supp. 710) that the decedent had reserved only the right to grant additional powers "of an administrative or managerial nature . . . necessary to the orderly and effective administration of said trust, and that no such provision or any other provision of said trust permitted the decedent to change the economic benefits of the property held in trust," and that this reserved power was not embraced by §2038. The appellate court held that even if the decedent could have conferred additional "plenary" powers on the trustee, the powers so conferred would have been exercisable only by the trustee, so that any change in beneficial enjoyment would have been made by the trustee rather than by the grantor. For a contrary result, see Fidelity Union Trust Co. v. United States, 126 F. Supp. 527 (Ct. Cl. 1954).

5. *Decedent's right to compel distributions to himself.* If the third person is authorized by the trust instrument to make distributions to the grantor should he suffer unusual medical expenses or a financial misfortune, is the property includible in the grantor's gross estate? A line of cases decided under the 1939 Code holds that if the third person's power is restricted by a definite external standard, so that the grantor could compel him to act when the contingency occurs, part or all of the trust corpus is subject to estate tax. Blunt v. Kelly, 131 F.2d 632 (3d Cir. 1942); Bankers Trust Co. v. Higgins, 136 F.2d 477 (2d Cir. 1943); Estate of Rosenwasser v. Commissioner, 5 T.C. 1043 (1945). These cases rest on §811(c) of the 1939 Code, requiring the inclusion in the gross estate of transfers intended to take effect in possession or enjoyment at or after the transferor's death, rather than on what is now §2038. (Supra p. 1143.) Would §2038 reach such transfers, on the ground that the grantor's power to compel the third person to distribute income or corpus to him when the contingency occurs is a power to "alter, amend, or revoke"? Remember that in Jennings v. Smith, supra page 1155, involving a cognate problem, the court held that a power exercisable only upon the occurrence of a stipulated event was not embraced by §2038 if the event had not occurred at the time of the decedent's death. If the power is exercisable in the grantor's favor, however, and he can compel its exercise, does he have an "interest" that is includible under §2033? If so, how is it to be valued? See United States National Bank v. United States, 188 F. Supp. 332 (D. Ore. 1960).

Consider the estate tax consequences of the transfer in Holtz's Estate v. Commissioner, supra page 1013. Is it possible that a transfer of this type would be subject to neither the gift tax nor the estate tax?

6. *References.* Lowndes, Some Doubts About the Use of Trusts to Avoid the Estate Tax, 47 Minn. L. Rev. 31 (1962); Leary, Termination of Inter Vivos Trusts Under State Law and the Internal Revenue Code Section 2038, 47 Marq. L. Rev. 165, 323, — (1963-1964).

CAMP v. COMMISSIONER

195 F.2d 999 (1st Cir. 1952)

Before MAGRUDER, Chief Judge, and WOODBURY and HARTIGAN, Circuit Judges.

MAGRUDER, Chief Judge.

Frederic E. Camp petitions for review of a decision of the Tax Court entered November 7, 1950, holding that petitioner was deficient in his gift tax for the year 1937 in the amount of $55,737.08, and for the year 1943 in the amount of $1,839.99. Primarily, the issue relates to the year 1937; the Tax Court's determination as to 1937 resulted in an upward revision of the figure for taxpayer's net gifts for the years prior to 1943, and thus, as a mere matter of mathematical

computation, in a determination of a deficiency in taxpayer's gift tax liability for other gifts made by him in 1943.

The dispute centers about the effect of a transfer in trust made by the taxpayer in 1932, prior to the enactment of the Revenue Act of 1932, §501 of which imposed a tax on gifts. Petitioner insists that this transfer in trust was a completed gift of the whole corpus, so that the transaction in its entirety was outside the incidence of the gift tax subsequently enacted. The Tax Court has held, however, that there was no completed gift at all in 1932, because the donor reserved in the deed of trust full power to alter, amend, or revoke, in conjunction with his half brother, who, the court concluded, had no "substantial adverse interest" in the trust property; and that there was a completed gift of the whole of the corpus of the trust in 1937, when the trust instrument was amended so as to vest the power of further amendment or revocation in the donor in sole conjunction with the donor's wife, who had a life interest in the trust income.

We are unable to accept altogether either the taxpayer's argument or the conclusion of the Tax Court. This segment of tax law, as to when a transfer in trust is to be deemed a completed gift for purposes of the gift tax, has been in a somewhat cloudy state, as perhaps is evident from the fact that in the present case the Commissioner has taken several successive positions, each asserting a larger deficiency for the years in question.

The case was tried in the Tax Court upon a stipulation of facts, supplemented by a deposition by petitioner which was read into evidence.

On October 30, 1931, the taxpayer married Alida Donnell Milliken. No children have issued from this marriage; but at various dates within the period January 19, 1937, to October 3, 1942, taxpayer and his wife have adopted four children.

On February 1, 1932, taxpayer executed a trust indenture naming Bankers Trust Company of New York as trustee, and transferred to said trustee, as corpus of the trust, securities then having a fair market value of $416,131.72.

The trust instrument provided that the income should be payable to taxpayer's wife Alida during her life, and that upon her death the principal of the trust should be paid to the then living issue of the donor per stirpes; and in default of such issue, that the trustee should continue to hold the principal in trust, paying the income therefrom to Johnanna R. Bullock, mother of the donor, during her life, and upon her death, that the trustee should pay the principal of the trust fund unto H. Ridgely Bullock, half brother of the donor, or if he be then dead, unto the then living issue of said H. Ridgely Bullock per stirpes, or if there be none, to the trustees of Princeton University.

The tenth article of the trust indenture provided:

> This indenture shall not be subject to revocation, alteration or modification by the Donor, alone, but nevertheless, he may, in conjunction with either H. Ridgely Bullock or Johnanna R. Bullock, beneficiaries hereunder, during the continuance of this trust, by instrument, in writing, executed and acknowledged by the Donor and either the said H. Ridgely Bullock or the said Johnanna R. Bullock, . . . modify or alter in any manner, or revoke in whole or in part, this indenture and the trusts then existing, and the estates and interests in property hereby created. . . .

When the trust was thus created in February, 1932, taxpayer's wife Alida was 23 years of age, his mother Johnanna R. Bullock was 63, and his half brother H. Ridgely Bullock was 22.

On August 30, 1934, the taxpayer, in conjunction with Ridgely, exercised the power to alter or amend by inserting a provision that Alida, wife of the donor,

should receive the income of the trust only so long as she, during the donor's lifetime, should continue to be his wife and to reside with him.

On December 11, 1937, the taxpayer, in conjunction with Ridgely, exercised the amendatory power so as to provide that the term "issue of the Donor," as used in the trust instrument, should be deemed to include any child or children then or thereafter legally adopted by the donor and his said wife, and their issue. At the same time the trust instrument was further modified so as to strike out the above-quoted provision in the tenth article with reference to the power to alter, amend or revoke, and to substitute in lieu thereof a provision containing the same words except that the name of Alida Donnell Milliken Camp was substituted for the names of H. Ridgely Bullock and Johnanna R. Bullock. Thus, on and after December 11, 1937, taxpayer reserved the power to alter, amend or revoke the trust in sole conjunction with his wife Alida, who was entitled to all the income from the trust during her lifetime, with the qualification previously stated.

The fair market value of the corpus of the trust, as of December 11, 1937, was $518,089.76.

On June 6, 1946, the taxpayer, in conjunction with his wife Alida, further modified the trust instrument by striking out in its entirety the provision of the tenth article, as amended, dealing with the power to alter, amend or revoke, and substituting in lieu thereof an unqualified provision that the trust indenture "shall not be subject to revocation, alteration or modification."

Section 501(c) of the Revenue Act of 1932 contained the following specific provision:

> The tax shall not apply to a transfer of property in trust where the power to revest in the donor title to such property is vested in the donor, either alone or in conjunction with any person not having a substantial adverse interest in the disposition of such property or the income therefrom, but the relinquishment or termination of such power (other than by the donor's death) shall be considered to be a transfer by the donor by gift of the property subject to such power, and any payment of the income therefrom to a beneficiary other than the donor shall be considered to be a transfer by the donor of such income by gift.

This subsection was repealed in 1934, 48 Stat. 758, for the reason, as explained in the committee reports, that "the principle expressed in that section is now a fundamental part of the law by virtue of the Supreme Court's decision in the *Guggenheim* case [supra p. 1007]. . . ."

It is to be noted that the facts of the *Guggenheim* case were narrower than the situations specifically covered in §501(c), in that the Supreme Court was not passing upon the case where the donor did not reserve to himself alone the power of revocation, but vested such power in himself in conjunction with some other person who might or might not have had a substantial adverse interest in the disposition of the property or the income therefrom. However, the committee reports in 1934 expressed the view that this latter situation was covered in principle by the Supreme Court's decision in the *Guggenheim* case, and therefore recommended the repeal of §501(c) because it had become unnecessary and superfluous.

What, then, was this "principle" recognized in the *Guggenheim* case? We think it is to be found in the Court's opinion [supra p. 1009], that the gift tax was not aimed at every transfer of the legal title without consideration, which would include a transfer to trustees to hold for the use of the grantor, but was aimed, rather, "at transfers of the title that have the quality of a gift, and a gift is not consummate until put beyond recall."

Subsequent cases have elaborated upon this concept of a "gift," and have settled that a transfer in trust is incomplete as a gift, not only where the donor

reserves the power to revest the trust property in himself, but also where he reserves the power to alter the disposition of the property or the income therefrom in some way not beneficial to himself. Estate of Sanford v. Commissioner [supra p. 1150]; Rasquin v. Humphreys, 1939, 308 U.S. 54. See the discussion in Higgins v. Commissioner, 1 Cir., 1942, 129 F.2d 237.

Treasury Regulations [§25.2511-2] contain the following provisions, which we take to be declaratory of the intent of the Act and of the gloss which later cases have put upon the concept of a "gift" as expressed in Burnet v. Guggenheim:

(b) As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or many be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined. . . .

(c) A gift is incomplete in every instance in which a donor reserves the power to revest the beneficial title to the property in himself. A gift is also incomplete if and to the extent that a reserved power gives the donor the power to name new beneficiaries or to change the interests of the beneficiaries as between themselves unless the power is a fiduciary power limited by a fixed or ascertainable standard. . . .

(d) A gift is not considered incomplete, however, merely because the donor reserves the power to change the manner or time of enjoyment. . . .

(e) A donor is considered as himself having a power if it is exercisable by him in conjunction with any person not having a substantial adverse interest in the disposition of the transferred property or the income therefrom. A trustee, as such, is not a person having an adverse interest in the disposition of the trust property or its income.

(f) The relinquishment or termination of a power to change the beneficiaries of transferred property, occurring otherwise than by the death of the donor (the statute being confined to transfers by living donors), is regarded as the event which completes the gift and causes the tax to apply. . . .

Where a donor makes a transfer in trust for numerous beneficiaries, it is obvious that there may be several distinct gifts or potential gifts. For purposes of the gift tax, some of the interests created may be completed gifts, and others may not be, depending upon the facts of the particular case — as is stated in the first paragraph of the above quotation from [§25.2511-2] of the regulations.

From the foregoing, we think the following propositions are reasonably clear:

(1) If the trust instrument gives a designated beneficiary any interest in the corpus of the trust property or of the income therefrom, which is capable of monetary valution, and the donor reserves no power to withdraw that interest, in whole or in part, except with the consent of such designated beneficiary, then the gift of that particular interest will be deemed to be complete, for the purposes of the gift tax. See accord, our discussion in Commissioner v. Prouty, 1 Cir., 1940, 115 F.2d 331, 334, with reference to the annuities to the husband in Trusts 2 and 3. This is true, though at the time of the creation of the trust there might be extraneous considerations, whether of a pecuniary or sentimental nature, which would give the donor every confidence that such designated beneficiary would acquiesce in any future desire of the donor to withdraw the gift, in whole or in part. See Commissioner v. Prouty, supra at page 335-336.* In that respect the

* "Examining these intimate family trusts, one must recognize an element of unreality in the inquiry whether a beneficiary's interest is substantially adverse to the grantor. The supposition is that, given a sufficient stake in the trust, the beneficiary is not likely to yield to a wish of a grantor to revoke the trust. In many cases the grantor may have full confidence in the compliant disposition of the member of the family he selects to share his power of revocation, even though

donor is taken at his word; he has legally given away something which he cannot take back except with the consent of the donee. The transfer fulfills the concept of a completed gift, quite as much as if a husband makes an outright gift of securities to his wife, being confident that his wife would reconvey the securities to him if he ever asked for them. If there were an advance agreement between the donor and the donee, prior to the transfer in trust, to the effect that the donee would acquiesce in any future exercise of the power of modification proposed by the donor, then the situation would be different. The trust instrument would not express the true intention of the parties.† A real gift is not intended, where the purported donee has agreed ahead of time to hold the "gift" subject to the call and disposition of the purported donor.

(2) If the only power reserved by the donor is a power to revoke the entire trust instrument (not a power to modify the trust in any particular), and this power may be exercised only in conjunction with a designated beneficiary who is given a substantial adverse interest in the disposition of the trust property or the income therefrom, then the transfer in trust will be deemed to be a present gift of the entire corpus of the trust, for purposes of the gift tax. In such cases, the gift of the entire corpus will be deemed to have been "put beyond recall" by the donor himself.

(3) If the trust instrument reserves to the donor a general power to alter, amend or revoke, in whole or in part and this power is to be exercised only in conjunction with a designated beneficiary who has received an interest in the corpus or income capable of monetary valuation, then the transfer in trust will be deemed to be a completed gift, for purposes of the gift tax, only as to the interest of such designated beneficiary having a veto over the exercise of the power.[1] As to the interests of the other beneficiaries, the gifts will be deemed to be incomplete, for as to such interests the donor reserves the power to take them away in conjunction with a person who has no interest in the trust adverse to such withdrawal. The gifts to the other beneficiaries have not been "put beyond

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such member is named as beneficiary of a handsome interest in the trust. The very fact that the grantor reserved a power to revoke indicates a mental reservation on his part as to the finality of the gift; and if the grantor wishes to hold on to a power of recapture, it stands to reason he will vest the veto power in someone whose acquiescence he can count on. Cf. Helvering v. City Bank Farmers Trust Co., 296 U.S. 85, 90. However, we cannot read into the gift tax, any more than into [§§676-677], the proposition that a member of the grantor's immediate family can never be deemed to have 'a substantial adverse interest.' So far as the gift tax is concerned, it is fair enough to take the grantor at his word. As to the income tax, it might be rational for Congress to tax all family income as a unit. But as the law now stands — both gift tax and income tax — we must give weight to the formal rights conferred in the trust instrument in determining whether a given beneficiary has a substantial adverse interest, bearing in mind the admonition of Helvering v. Clifford, 309 U.S. 331, 335, that 'where the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement is necessary. . . .' " — Ed.

† For an application of this principle, see Publicker v. Miles, 48 A.F.T.R. 1968 (E.D. Pa. 1955), where the terms of a trust which would have been a taxable gift if taken at face value were disregarded on evidence that the trustee had agreed with the donor that the corpus would be returned to her on request and that a provision permitting the donor to revoke only with the consent of her husband was inserted by an attorney without the donor's knowledge and in violation of her intention. — Ed.

1 This proposition is subject to qualification in the rather unusual situation like that presented by Trust No. 1 in Commissioner v. Prouty, C.A. 1, 1940, 115 F.2d 331. There under the terms of the trust instrument, the grantor reserved a power to revoke or amend, with the written consent of her husband. Although the husband was not given the entire beneficial interest in the trust property, nevertheless he did have substantial interests, both in the disposition of the income and in the disposition of the corpus, which were adverse to any modification of the trust other than by way of augmenting the husband's interests. In these circumstances we held that there had been a completed gift of the entire corpus.

recall" by the donor; in such cases the regulation recognizes realistically that when the donor has reserved the power to withdraw any of the donated interests with the concurrence of some third person who has no interest in the trust adverse to such withdrawal, it is in substance the same as if the donor had reserved such power in himself alone. In further support of this proposition, see the discussion in Estate of Sanford v. Commissioner [supra p. 1150].

Coming back, then, to the terms of the trust which petitioner created in February, 1932: It is clear that there was not at that time a completed gift of the life income to petitioner's wife Alida. Under the original provisions of the trust indenture, this life estate was subject to revocation by the donor in conjunction either with the donor's half brother Ridgely or his mother Johnanna, neither of whose interests in the trust were adverse to the withdrawal of the life estate from Alida.

When the trust instrument was amended on December 11, 1937, so as to transfer to Alida alone the veto power over any further proposals by the donor for amendment of the trust, there was on that date a completed gift to Alida of the interest which she then held in the trust. It is stipulated that the value on December 11, 1937, of the income of a trust having a principal value of $518,089.76, payable during life of a woman of 29 (Alida's age), was $356,492.38. However, it is to be noted that Alida did not at this time hold an absolutely unqualified life interest in the income. By prior amendment, the indenture provided that the income of the trust was to be payable to Alida, wife of the donor, only "as long as she, during his lifetime, shall continue to be his wife and to reside with him." Whether, in the valuation of the gift to Alida on December 11, 1937, some allowance should be made for this qualification upon the life estate, we do not undertake to say. Cf. Robinette v. Helvering [infra p. 1227]. The Tax Court was in error, we think, in ruling that upon the execution of the amendment of December 11, 1937, petitioner made a taxable gift of the whole corpus of the trust, valued then at $518,089.76. There were at that time no completed gifts to the succeeding income beneficiaries and beneficiaries in remainder, for Alida's interest in the trust was not adverse to the donor's revocation of those succeeding interests by an exercise of the reserved power.

By the amendment of June 6, 1946, whereby all power to revoke, alter or modify the trust was eliminated, there resulted a taxable gift of the then value of the corpus, minus the sum determined to be the value of the gift to Alida on December 11, 1937, and minus also the values of any completed gifts which may be deemed to have been made at the time of the creation of the trust on February 1, 1932. This latter point we do not have to determine in the present case, because petitioner's liability for the year 1946 is not before us. In passing, we simply allude to a possible difficulty, in that the donor originally reserved a power to revoke or modify the trust in conjunction with either Ridgely or Johnanna. Ridgely's contingent remainder interest might have been revoked by the donor, in conjunction with Johnanna, whose interest in the trust was not adverse to such revocation. Johnanna's contingent life estate could have been revoked by the donor in conjunction with Ridgely, whose interest in the trust was not adverse to such revocation. Where the veto power is thus lodged in the alternative, it may be that, for purpose of the gift tax, there is not a completed gift to either of such beneficiaries. But cf. Estate of Leon N. Gillette, 1946, 7 T.C. 219; Commissioner v. Betts, 7 Cir., 1941, 123 F.2d 534.

The decision of the Tax Court is vacated, and the case is remanded to that court for further proceedings not inconsistent with this opinion.

NOTE

1. *"Subtantial adverse interest" and the happy family.* In *Camp* and *Prouty,* the court refused to accept the theory that a "substantial adverse interest" cannot exist within a happy family unit. The *Prouty* case also commented on a cognate problem: whether a trustee or other person whose consent is required to an amendment or other change in a trust has an adverse interest if his exercise of the power will adversely affect a member of *his* family:

> Another point was stressed by the Board of Tax Appeals in connection with Trusts Nos. 2 and 3, namely, that in each case the corpus at the death of Lewis, whose consent to change was required, was to go to his children. "It is natural to assume," said the Board, "that his desire and concern for the support, maintenance, and welfare of his children after his death would prompt him to resist any effort on the part of the grantor of the trust to alter, amend or revoke that part of the trust so as to revest in her title to such property." No doubt this is an interest of a sort. But we think the phrase "substantial adverse interest," as it was used in Section 501(c) of the Revenue Act of 1932 and as it is used in Sections 166 and 167 [1939 Code], means a direct legal or equitable interest in the trust property and not merely a sentimental or parental interest in seeing the trust fulfilled for the advantage of other beneficiaries. [115 F.2d 331, 335 (1st Cir. 1940).]

What if the beneficiaries whose enjoyment will be adversely affected by the trustee's action are his minor children, whom he is obligated to support? In Latta v. Commissioner, 212 F.2d 164 (3d Cir. 1954), cert. denied, 345 U.S. 825, the court held that the estranged husband of the settlor of a trust did not have a substantial adverse interest, although their minor children were the remaindermen. One judge dissented, with opinion.

For the income tax aspects of the "substantial adverse interest" problem, see Joseloff v. Commissioner, supra page 367. The term "substantial adverse interest" was taken by the gift tax regulations from §501(c) of the Revenue Act of 1932, as the *Camp* case points out, and this statute took it from the statutory provisions governing the grantor's *income* tax liability on the income of a revocable trust. The common use of the term thus effected a degree of co-ordination between the gift tax and the income tax, supra page 370. In 1954, the term "substantial adverse interest" was dropped from the income tax provisions and the concept of "adverse" and "non-adverse" parties was substituted. An "adverse party" is defined by §672(a) as a person "having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non exercise of the power which he possesses respecting the trust." Apparently no substantive change in the law was intended. S. Rept., p. 365.

2. *Power of alteration vested solely in third person.* Except in circumstances similar to those in Holtz' Estate v. Commissioner, supra page 1013, a transfer is complete for gift tax purposes even though the interests of the beneficiaries can be reshuffled by a third person, if he is "neutral" and can act without the consent of the donor or a person having a substantial adverse interest. Regs. §25.2511-2(b); Higgins v. Commissioner, 129 F.2d 237 (1st Cir. 1942), cert. denied, 317 U.S. 658. Since no gift tax is imposed on a transfer if the grantor can revoke only with the consent of such a "neutral" person, however, why should a power vested solely in him be treated differently?

3. *Where the Decedent's Power Is to Modify a Transfer Made by Another*

NEWBERRY'S ESTATE v. COMMISSIONER

201 F.2d 874 (3d Cir. 1953)

Before GOODRICH, KALODNER and HASTIE, Circuit Judges.

HASTIE, Circuit Judge.

In these petitions for review the taxpayers complain that the Tax Court has

improperly applied to the estate of Myrtle H. Newberry, deceased, the provisions of [§2038(a)(2)], that the gross estate shall include any property interest which decedent may have transferred in trust, where at the time of his death, the enjoyment of that interest was subject to change through exercise by the decedent of a power to alter or revoke. It is admitted that the trusts in controversy gave the decedent until her death such power of alteration. But they were created by transfer of her husband's property under a trust indenture executed solely by him. Nevertheless, the Tax Court, upholding the Commissioner of Internal Revenue, has ruled that in the particular circumstances of this case the decedent may properly be regarded and taxed as the transferor of the trust property within the meaning of [§2038(a)(2)]. 17 T.C. 597.

In 1934 both John J. Newberry and his wife, Myrtle H. Newberry, were independently wealthy. Among other holdings, each owned about 50,000 shares of J. J. Newberry Company common stock, then valued at more than $50 per share. The Newberrys were deeply concerned for the future well being of their young children, a son and a daughter, neither of whom had independent means. In 1934 John Newberry created an irrevocable trust of 2500 shares of J. J. Newberry Company common stock for his daughter and a like trust for his son. In 1935 he repeated the process. In each trust he named himself and his wife as trustees and gave Mrs. Newberry alone broad power to alter, amend or terminate the trust, but in no event to revest principal or income in him. Before Mrs. Newberry's death in 1944, this power had been so limited by amendment of each instrument that no more could be done in its exercise than to shift interests among the Newberry issue, spouses of such issue and charities. Other amendments of the trusts were made from time to time but their provisions have no bearing upon this case.

On each occasion when Mr. Newberry executed one of these trusts Mrs. Newberry similarly executed a trust placing 2500 of her shares of J. J. Newberry Company common stock in trust for the same child. In each case she named herself and her husband as trustees and gave him the same powers of alteration as she was granted in the trusts created by him. Each time the husband amended the trusts he had created the wife made identical or equivalent changes in those she had created.

The Tax Court, in its findings of fact, had this to say about the circumstances under which these trusts were established:

> The idea of creating these trusts was first suggested to John J. Newberry by his brother, his business associate. After discussing the matter with his brother, John J. Newberry called in his attorney, with whom he discussed a plan that his brother had suggested. After John J. Newberry had the idea of creating the trusts "pretty well" fixed in his mind and shortly after he had first discussed it with his attorney he discussed it with his wife. He and she usually talked over matters as important as the trusts. They always handled the affairs of the family mutually. When decedent joined her husband and the attorney in the discussion she said that ". . . if it was a good thing to create these trusts, if John thought it was a good thing to create these trusts for the children, she did, too. She thought it was an excellent idea, and she wanted to do the same thing. She wanted to create the same type of trusts."
>
> He suggested the trust idea to her; she was interested right away and thought it was a good plan. Her purpose in creating her two 1935 trusts was the same as his. The decedent never gave any indication that she might not possibly execute the trusts. . . .
>
> The Newberry children at the time of the creation of the trusts in 1934 and 1935 had no independent means of their own. They were very young and the decedent and her husband did not know what kind of lifemates they might choose. They had a great interest in the children and wished to protect their interest.

In addition, Mr. Newberry was positive in his testimony, and it was in no way rebutted, that he would have created his trusts regardless of whether Mrs. New-

berry had decided upon a similar course. He also testified that the property placed in trust represented a small fraction of the wealth of each spouse and that neither of them contemplated any personal benefit or gain from corpus or income of any of the trusts.[1] Mr. Newberry testified further and the Tax Court found that powers to shift beneficial interests were incorporated in the trust indentures so as to make sure that no "schemers or ne'er-do-wells" should obtain control of the property in the unhappy event of an unfortunate marriage by either of the children for whose security the trusts were designed.

On this showing the Tax Court reached ultimate factual conclusions that in establishing, and from time to time amending, these trusts "the decedent and her husband were acting as a unit . . . and that the trust instruments were merely part of an interdependent arrangement whereby neither decedent nor her husband would lose control of the amount of the J. J. Newberry Company stock transferred to the trusts until they saw fit to do so." On this basis, the Tax Court ruled that Mrs. Newberry should be regarded as the settlor of the trusts created by her husband as well as the holder of a power to change the enjoyment of the trust estate. . . .

The narrow question is whether the Tax Court erred in treating Mrs. Newberry as the person who had "made a transfer" of this property in trust within the meaning of [§2038(a)(2)].

Normally taxing authorities and courts administering or applying a statute which taxes to a transferor's estate property he has transferred in trust reserving certain powers to himself have no occasion to go beyond the trust instrument in order to identify the transferor. At times, however, they have gone further. This procedure has been justified as necessary and proper to determine whether the significant shifting of economic interests and the change of dominion and control over property has been different from what the trust instrument itself indicates. And if such analysis shows that another than the formal settlor is in reality the transferor, his estate may be taxed accordingly.

The most obviously appropriate occasion for the application of the principle would be presented by a transaction in which one of the formal parties had been essentially a "straw" acting for someone else. Tax consequences, like many other legal and economic consequences of such a transaction, would attach to the real party in interest. A like result is clearly proper where, pursuant to a bargain and exchange, one party has given value to another to induce, and in consideration for, the creation of a trust by the second party wherein disposition is made of some beneficial interest as desired by the first party. Indeed, the taxing authorities need do no more than apply considered and accepted doctrine of the law of trusts to reach the conclusion that he who pays another for the creation of a trust wherein the payor shall be granted a beneficial interest or a power which he desires may be taxed as one who has transferred property retaining an interest therein. This doctrine has been recognized and applied in a line of cases beginning with Lehman v. Commissioner of Internal Revenue, 2 Cir., 1940, 109 F.2d 99. That leading case clearly turned upon the court's reasoning that "the transfer by the decedent's brother, having been paid for and brought about by the decedent, was in substance a 'transfer' by the decedent, and property so transferred formed part of his taxable estate by virtue of [§2038(a)(2)], to the extent that the decedent had power to 'alter, amend or revoke' the enjoyment of it." 109 F.2d at pages 100-101.

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1 These were New Jersey trusts. Whether the trustee could have employed his power to shift beneficial interests for his own advantage is as a matter of law at least doubtful. . . . In any event it seems clear on the record that no such use of the power was intended or contemplated when the trusts were established. And it is agreed that amendments prior to decedent's death precluded any such use of the power.

It was also a fact in the *Lehman* case that the way the decedent, who was treated as transferor, had paid his brother for setting up the trust in question had been by setting up a similar trust conferring an equivalent benefit upon his brother. Thus, procedurally, the establishment of "reciprocal" or "crossed" trusts was a technical device for realizing the quid pro quo of a bargain.

The foregoing analysis is important because some of the subsequent cases which apply the *Lehman* doctrine have stressed the fact that trusts contained "reciprocal" or "crossed" provisions without spelling out that this circumstance is significant only to the extent that it may reveal a quid pro quo which another than the named grantor has paid for the creation of the trust in controversy. Actually, some of the cases seemed to go rather far in inferring such payment or consideration in connection with reciprocal or crossed provisions. But this court in In re Lueders' Estate, 3 Cir., 1947, 164 F.2d 128, has taken the lead in indicating that payment for the creation of a trust by another must be real if the alleged payor rather than the apparent settlor is to be treated as grantor of the trust. The essential picture which the crossed trusts must reveal to justify the result reached by the Tax Court in the present case is a declared grantor induced to establish a trust giving the party now to be treated for tax purposes as the grantor, a power which the latter has wanted and has paid for by setting up another trust to accomplish something desired by the declared grantor. Such in our view are the rather strict confines of the *Lehman* doctrine.

What the Tax Court found in this case, and what happened, if the undisputed testimony is to be believed, falls short of the foregoing requirements. The "unity" of action of husband and wife and the "interdependent" character of their transactions which the Tax Court found are not such circumstances as the *Lehman* doctrine comprehends. Spouses in mutual confidence and common interest work out together what each is going to do with his own money to provide for their children. In the normal case, which this appears to be, it is a distortion of meaning to say that the action of one spouse is a quid pro quo inducing the action of the other. The only "consideration" is the historic "consideration of love and affection" for the dependent members of one's family. Similarity of action occurs because each spouse is confident that they together have arrived at a wise and benevolent decision concerning the future welfare of their children. That is all there is to the "unity" and "interdependence" of action revealed by such a record as we have here. Neither the substance of the transaction nor the identity of the actor is revealed as any different from what appears on the face of each trust indenture.

We have also considered that in the present decision and one or two others, the Tax Court may well be treating as special cases to be governed by rules of construction peculiar to them family trusts so created that husband and wife by separately granting each other powers over the enjoyment of trust property achieve essentially the same controls as would have resulted from reserving powers. Undoubtedly, in this connection as in others, domestic privacy and informality may effectively conceal understandings made and honored between husband and wife at variance with the formal and apparent aspects of family financial transactions. A bargain and exchange, within the meaning of the *Lehman* doctrine may exist, yet be unprovable. Moreover, regardless of any such bargain, there may be policy considerations favorable to legislation which for particular tax purposes would treat these crossed trusts of spouses like a single joint transaction with both spouses pro tanto transferors of the property over which each will thereafter have certain control. But, absent such legislation, when on the facts the conclusion is inescapable that each spouse by a distinct and bona fide transaction has dispensed of his own separate estate in accordance with his own personal desires and without receiving a quid pro quo from the other, we

think a court cannot justifiably refuse to recognize each spouse as the real transferor of the trust he has formally created.

In the present case Mr. Newberry himself executed an operative indenture to transfer his own property in trust for the benefit of his children, pursuant to his personal desire to provide for their security. Of course, the total result of this transaction and the companion transaction of Mrs. Newberry, with each spouse granting a power to the other, could have been achieved by each spouse reserving a power in the trust he created. We have no doubt that the parties, advised by counsel, deliberately chose the alternative which appeared to entail the less burdensome tax consequences. But tax saving motivation does not justify the taxing authorities or the courts in nullifying, or disregarding, the taxpayer's otherwise proper and bona fide choice among courses of action. . . .

The decisions of the Tax Court will be reversed and the cases remanded for the entry of dispositive orders consistent with this opinion.

NOTE

1. *Reciprocal trusts.* In Hill's Estate v. Commissioner, 23 T.C. 588 (1954), transfers in the form of reciprocal trusts were held made in contemplation of death because a complicated form was employed to avoid estate taxation. By reason of a later judicial construction of the statute, had the transfers been made in the normal manner, estate taxes would not have been due!

See Rev. Rul. 56-397, 56-2 C.B. 599, ruling that the reciprocal transfer doctrine is not applicable to the common arrangement among partners or other business associates, by which each purchases insurance on the life of the other in order to meet his obligation under an agreement to buy out the interest of the first to die.

2. *Gift tax consequences of reciprocal trusts.* For the troublesome gift tax aspects of reciprocal trusts, see Commissioner v. McLean, 127 F.2d 942 (5th Cir. 1942); Commissioner v. Warner, 127 F.2d 913 (9th Cir. 1942).

3. *Identifying the transferor.* Aside from the reciprocal trust area, it is sometimes necessary to determine whether the decedent was the transferor of property if he gave it to someone else on condition that the latter place it in trust, or if the decedent placed property in trust after receiving it from another person. See First National Bank of Shreveport v. United States, 224 F. Supp. 747 (W.D. La. 1963), and cases there cited; State Street Trust Co. v. United States, infra page 1193.

4. *Reference.* Colgan and Molloy, Converse Trusts — The Rise and Fall of a Tax Avoidance Device, 3 Tax L. Rev. 271 (1948).

FEDERAL ESTATE AND GIFT TAXES: A PROPOSAL FOR INTEGRATION AND FOR CORRELATION WITH THE INCOME TAX

Joint Study of Advisory Committee to Treasury Department and Office of Tax Legislative Counsel 18-21 (1947)

It is proposed under this heading that a transfer shall be deemed incomplete and therefore not subject to transfer tax if the transferor, any other person, or both retain a power of revocation, alteration, amendment, or termination enabling a change in the beneficial disposition of the property or the income therefrom. The transfer is rendered complete when all such authority finally comes to an end. If the power ceases during life, the transfer tax is incurred in the calendar year in which such cessation occurs. But if the power is outstanding at the transferor's death, the transferred property is treated as part of his taxable estate at death. A power held solely by another person, however, does not render a transfer incomplete if such person is authorized to vest the property in himself as well as others. In a similar connection, a power to change the beneficial dis-

position of the property does not postpone the completion of the transfer if such power is exercisable solely by will by a person other than the transferor. Finally, a transfer is deemed complete even though the transferor or others have power (*a*) to distribute or apply income to or for a current income beneficiary or to accumulate it for him; (*b*) to apply principal to or for the benefit of the income beneficiary of such portion; or (*c*) to effect a combination of these results.

The precise scope of the foregoing recommendation may be more easily appraised by comparing it with the existing gift- and estate-tax rules. At present a transfer is incomplete for gift-tax purposes if the transferor, either alone or in conjunction with a person lacking a substantial adverse interest, is empowered to revoke the transfer, to designate new beneficiaries, or to alter the relative interests of the named beneficiaries. See Reg. [§25.2511-2]; Burnet v. Guggenheim [supra p. 1007]; Estate of Sanford v. Comm. [supra p. 1150]. On the other hand, if such a power over beneficial enjoyment is held by the transferor in conjunction with a person having a substantial interest adverse to another disposition, or is held solely by a person other than the transferor, the transfer constitutes a completed gift. See Comm. v. Prouty, 115 F.(2d) 331 (C.C.A.1st, 1940); Higgins v. Comm., 129 F.(2d) 237, 242 (C.C.A.1st, 1942) cert. den. 317 U.S. 658 (1942). Insofar as the estate tax is concerned, a transfer is taxable at death if the transferor alone or in conjunction with any person is authorized to change the enjoyment of the property through the exercise of a power to alter, amend, revoke or terminate. If the power is held solely by a person other than the transferor, the property subject to the power is not includible in the transferor's gross estate, unless a power to revest the property in him is exercisable in accordance with some standard enforceable in a court of equity, and not as the donee may freely determine. Compare Blunt v. Kelly, 131 F.(2d) 632 (C.C.A.3d, 1942), with Comm. v. Irving Trust Co., 147 F.(2d), 946 (C.C.A.2d, 1945). Cf. the somewhat intermediate position in Bankers Trust Co. v. Higgins, 136 F.(2d) 477 (C.C.A.2d, 1943).

If the gift tax rules are placed alongside those proposed under the integrated transfer tax, it is evident that the line in certain instances has been moved over so that transfers which would now be deemed completed gifts would be considered incomplete under the proposed transfer tax. This shift is caused primarily by two factors. First, the proposed revision drops the substantial adverse interest concept which is not a significant element in the determination of gift tax liability, inasmuch as this concept is not responsive to the actual controls retained by a transferor through familial and financial ties. Since the substantial adverse interest concept was eliminated from the estate tax law in 1924, the proposed transfer tax and the estate tax are thus identical in their treatment of a power held by the transferor alone or in conjunction with any other person.

Secondly, the proposed revision eliminates the distinction between a power held by the transferor in conjunction with another person and a power held solely by the other person. The present distinction assumes that a transferor exerts more influence upon another person as co-holder of a power rather than as transferor. As Congress has recognized since 1932 in connection with the income tax, however, any such distinction is unjustifiable and is self-defeating if avoidance is to be justly dealt with. . . . Accordingly, where the power to change the beneficial disposition of the property resides solely in a person other than the transferor, the integrated transfer tax seeks to establish a clear-cut rule that such a power postpones the completion of the transfer until death unless the power is relinquished at an earlier date.

The validity of the recommended rule seems beyond all reasonable doubt in view of Helvering v. City Bank Farmers Trust Company [supra p. 1158]. According to this decision, Congress may regard a transfer as incomplete if the transferor

retains a power to revise his disposition in conjunction with another person, including a beneficiary. Congress is free to assume that a beneficiary "of the grantor's immediate family might be amenable to persuasion" and that a grantor who desires to retain full dominion over the property will join with him in the exercise of his power someone who he believes "would comply with his wishes." Although the *City Bank* decision dealt with a power of which the transferor was a formal co-holder, its rationale is not predicated upon this technical factor. If amenability to the transferor's persuasion is the dominant criterion, amenability is little affected by presence or absence of the transferor as a co-holder of the power. It is the ability to exert control and the creation of means for doing so which are determinative.

While continued dominion and control may be manifested through others, a point is reached where it is fair to conclude that they have generally come to an end. Hence it is provided that if a person other than the transferor is free to vest the property in himself, the transfer is complete. Such a transfer is not appreciably different from one which directly vests outright ownership in the other person. It is further provided that if a power in another person to change the beneficial enjoyment of the property may be exercised only by will, the transfer is equally complete. Admittedly, a donee of a testamentary power may be amenable to persuasion to such an extent that he will revest the property in the transferor or his estate. But such a power, when held by another, is not, as a rule, a ready means of assuring a continuing dominion in the transferor. In addition, the attribution of another person's testamentary power to the transferor would severely cripple the taxability of powers of appointment which are deemed the equivalent of ownership in the donee for tax purposes.

The recommendation also provides that certain powers, which allow for a limited type of shifting in beneficial enjoyment, shall not render the transfer incomplete. Thus, the transferor will be required to pay a transfer tax at the time of transfer, and will thereafter be relieved from tax on the income from the transferred property, where he or another person has the power to distribute income to or for the benefit of a current income beneficiary or to accumulate it for future distribution to him. . . . [I]t is true that if distribution of income is withheld and the current income beneficiary of a trust dies prior to the expiration of the trust, the accumulations may ultimately pass to an alternate taker. Such a power of accumulation, however, is very limited in scope since its operation as a method of adjusting beneficial enjoyment depends upon the untimely death of the current income beneficiary. It is also provided that a transfer shall be deemed complete despite a power in the transferor or another person to pay over any portion of the principal to the current income beneficiary of such portion. Such a power of invasion undoubtedly permits continuation of dominion over the transferred property. It is believed, however, that transferors should not be entirely precluded from attempting to meet the needs of changing circumstances, such as a sudden emergency which requires immediate invasion of principal to assist the current income beneficiary. This consideration, it is felt, warrants the creation of a distinction between a limited power to invade and other powers to shift beneficial enjoyment.

NOTE

For other proposals looking toward a coordination of the income, estate, and gift taxes on inter vivos transfers, see American Law Institute, Federal Income, Estate and Gift Tax Statute (Tent. Draft No. 10, 1955) 175-216.

Section C. Transfers with Retained Life Estate: §2036

Development of "intended to take effect in possession or enjoyment at death" provision. From its enactment in 1916 until the adoption of the 1954 Code, the federal estate tax reached transfers "intended to take effect in possession or enjoyment at or after [the transferor's] death." It has already been noted (supra p. 1143) that from 1916 to 1924 revocable trusts were included in the gross estate by virtue of this statutory provision, and that in 1924 the predecessor of §2038 was enacted to deal in a more explicit fashion with transfers under which the transferor retained the right to alter, amend, or revoke. Thereafter, despite an overlapping area, the taxability of transfers of this type was primarily governed by the explicit statutory language of §2038 as modified from time to time, rather than by the more vague standard of the "postponed-possession-or-enjoyment" clause. The scope of §2038 is studied in Section B of this chapter.

A second type of transfer that was originally tested by the "postponed-possession-or-enjoyment" clause was the gift of property with a reservation by the donor of the right to receive or to control the income. In 1931, however, this type of disposition also received explicit statutory recognition. The governing statute is now §2036.

A third type of transfer that was formerly subject to the "postponed-possession-or-enjoyment" clause was a gift of property that might revert to the transferor's estate at or after his death. The statute was amended in time to deal specifically with this type of transfer too, but this did not occur until 1949. The current version of the 1949 legislation is §2037.

This development of a progressively more detailed statute culminated, in 1954, in the elimination of the original postponed-possession-or-enjoyment clause.* But the current provisions can hardly be understood without a few words of history.

Original understanding of "postponed-possession-or-enjoyment" clause. In 1916, when the postponed-possession-or-enjoyment clause was enacted, it was apparently generally believed that it brought into the gross estate property that had been transferred by the decedent during his lifetime if he reserved to himself the income from the property. The pre-1916 understanding of the clause has been described by the Supreme Court in Commissioner v. Estate of Church, 335 U.S. 632, 637-638 (1949), as follows:

> The "possession or enjoyment" provision . . . seems to have originated in a Pennsylvania inheritance tax law in 1826. Leighton, "Origin of the Phrase, 'Intended To Take Effect in Possession or Enjoyment At or After . . . Death' (§811(c), Internal Revenue Code)," 56 Yale L.J. 176 (1946). As early as 1884 the Supreme Court of

* In 1942, Paul complained: "We have been like Englishmen who never clean their slates; no language could be thrown away if anyone thought in optimistic vein that he understood its meaning. Amendments consisted of addition, duplication and overlapping. No one suggested the heroic remedy of fresh language which would clear away the debris and say simply what was plainly dictated by disillusioning experience with a statute that had repeatedly failed to say what the Treasury, at least, thought it meant. It was easier to repair at damaged points in a makeshift way, always hoping for a dim best. Some day we shall learn that sound revenue laws are not made in such a piecemeal way, and that postponing such important tax problems may be an expensive luxury." Paul, Federal Estate and Gift Taxation (1942) §7.01.

In the years that have followed Mr. Paul's complaint, the process of shoring up, rather than rebuilding, the structure has continued; and even the 1954 elimination of the original "postponed-possession-or-enjoyment" clause falls short of the "heroic remedy of fresh language" that he urged, since a truncated version was retained, albeit for a limited purpose, in §2036(a)(1) and §2037(a)(1).

Pennsylvania held that where a legal transfer of property was made which carried with it a right of possession with a reservation by the grantor of income and profits from the property for his life, the transfer was not intended to take effect in enjoyment until the grantor's death: "One certainly cannot be considered, as in the actual enjoyment of an estate, who has no right to the profits or incomes arising or accruing therefrom." Reish, Adm'r v. Commonwealth, 106 Pa. 521, 526. That court further held that the "possession or enjoyment" clause did not involve a mere technical question of title, but that the law imposed the death tax unless one had parted during his life with his possession and his title and his enjoyment. It was further held in that case that the test of "intended" was not a subjective one, that the question was not what the parties intended to do, but what the transaction actually effected as to title, possession and enjoyment.

Most of the states have included the Pennsylvania-originated "possession or enjoyment" clause in death tax statutes, and with what appears to be complete unanimity, they have up to this day [1949] substantially agreed with this 1884 Pennsylvania Supreme Court interpretation. Congress used the "possession or enjoyment" clause in death tax legislation in 1862, 1864, and 1898. . . . In referring to the provision in the 1898 Act, this Court said that it made "the liability for taxation depend, not upon the mere vesting in a technical sense of title to the gift, but upon the actual possession or enjoyment thereof." Vanderbilt v. Eidman, 196 U.S. 480, 493. And five years before the 1916 estate tax statute incorporated the "possession or enjoyment" clause to frustrate estate tax evasions, this Court had affirmed a judgment of the New York Court of Appeals sustaining the constitutionality of its state inheritance tax in an opinion which said: "It is true that an ingenious mind may devise other means of avoiding an inheritance tax, but the one commonly used is a transfer with reservation of a life estate." Matter of Keeney, 194 N.Y. 281, 287; Keeney v. New York, 222 U.S. 525.

See also Vanderlip v. Commissioner, 155 F.2d 152 (2d Cir. 1946), cert. denied, 329 U.S. 728, where Judge L. Hand said that such a transfer "is as nearly the substitute for a bequest as it can be and still remain a gift at all," hinting that the reservation of income from transferred property might ipso facto stamp the transfer as a gift in contemplation of death.

Treasury practice from 1916 to 1930 accorded with the interpretation of the postponed-possession-or-enjoyment clause described above. See Commissioner v. Estate of Church, supra, 335 U.S. at 639.

The "bombshell" of 1930: May v. Heiner. In 1930, however, the Supreme Court rejected this construction of the clause in May v. Heiner, 281 U.S. 238 (1930). The decedent in this case had transferred property in trust in 1917 to pay the income to her husband for his life and to her for her life if she survived him; upon the survivor's death, the trust was to terminate and the property was to be distributed to her children. The record did not disclose whether she had survived her husband, so as to come into present enjoyment of the income, or not; but the Court thought this was not relevant. Holding that the trust property was not part of the decedent-settlor's gross estate, the Court said:

> [The transfer in 1917] was not testamentary in character and was beyond recall by the decedent. At the death of Mrs. May no interest in the property held under the trust deed passed from her to the living; title thereto had been definitely fixed by the trust deed. The interest therein which she possessed immediately prior to her death was obliterated by that event. [281 U.S. at 243.]

After May v. Heiner was decided, there remained for the Treasury the hope that it could be confined to its own peculiar facts: the decedent had retained a contingent, or secondary, life estate, rather than a primary one. The next year, this hope was dashed when the Supreme Court decided Burnet v. Northern Trust Co., 283 U.S. 782 (1931), involving a trust under which the settlor retained a life

interest in the income, without the intervention of an intermediate life tenant. The Court said, per curiam:

> The question in this case is that of the construction of §402(c) of the Revenue Act of 1921, a provision similar to that of §402(c) of the Revenue Act of 1918, which has already been construed by this Court, and, in this view, there being no question of the constitutional authority of the Congress to impose prospectively a tax with respect to transfers or trusts of the sort here involved, the judgment of the Circuit Court of Appeals for the Seventh Circuit is affirmed upon the authority of May v. Heiner. . . . [283 U.S. at 784.]

The Joint Resolution of March 3, 1931. There was a dramatic climax to Burnet v. Northern Trust Co. and to two companion cases decided at the same time:

> March 3, 1931, the next day after the three per curiam opinions were rendered, Acting Secretary of the Treasury Ogden Mills wrote a letter to the Speaker of the House explaining the holdings in May v. Heiner and the three cases decided the day before. He pointed out the disastrous effects they would have on the estate tax law and urged that Congress "in order to prevent tax evasion," immediately "correct this situation" brought about by May v. Heiner and the other cases. He expressed fear that without such action the Government would suffer "a loss in excess of one-third of the revenue derived from the federal estate tax, with anticipated refunds in excess of $25,000,000." The Secretary's surprise at the decisions and his apprehensions as to their tax evasion consequences were repeated on the floor of the House and Senate. Senator Smoot, Chairman of the Senate Finance Committee, said on the floor of the Senate that this judicial interpretation of the statute "came almost like a bombshell, because nobody ever anticipated such a decision." * Both houses of Congress unanimously passed and the President signed the requested resolution that same day. [Commissioner v. Estate of Church, 335 U.S. at 639-640.]

Because Congress was scheduled to adjourn the following day, the resolution was adopted under a suspension of the rules and without having been printed, in reliance upon statements from the floor.

The Joint Resolution of March 3, 1931, enacted in such haste, provided for the inclusion in the gross estate of transferred property if the transferor retained for his life or any period not ending before his death (1) the possession or enjoyment of, or the income from, the property, or (2) the right to designate the persons who should possess or enjoy the property or the income therefrom.

In 1932, this provision was amended so as to give it the form now found in §2036(a), supra page 1177. The 1932 amendment was explained by the House Committee on Ways and Means:

> The purpose of this amendment . . . is to clarify in certain respects the amendments made to that section by the joint resolution of March 3, 1931, which were adopted to render taxable a transfer under which the decedent reserved the income for his life. The joint resolution was designed to avoid the effect of decisions of the Supreme Court holding such a transfer not taxable if irrevocable and not made in contemplation of death. Certain new matter has also been added, which is without retroactive effect.
>
> The changes are:
>
> (1) The insertion of the words "or for any period not ascertainable without reference to his death," is to reach, for example, a transfer where decedent reserved to himself semiannual payments of the income of a trust which he had established, but with the provision that no part of the trust income between the last semiannual payment to him and his death should be paid to him or his estate, or where he reserves the income, not necessarily for the remainder of his life, but for a period in the ascertainment of which the date of his death was a necessary element.

* It has been suggested that this was hyperbole. Pavenstedt, Congress Deactivates Another Bombshell: The Mitigation of Church and Spiegel, 5 Tax L. Rev. 309 n.155 (1950). — Ed.

(2) The insertion of the words "or for any period which does not in fact end before his death," which is to reach, for example, a transfer where decedent, 70 years old, reserves the income for an extended term of years and dies during the term, or where he is to have the income from and after the death of another person until his own death, and such other person predeceases him. This is a clarifying change and does not represent new matter.

(3) The insertion of the words "the right to the income" in place of the words "the income" is designed to reach a case where decedent had the right to the income, though he did not actually receive it. This is also a clarifying change.

(4) The insertion of the words "either alone or in conjunction with any person" is to reach a case where decedent had a right, with the concurrence of another person or persons, to designate those who should possess or enjoy the property or the income therefrom. [1939-1 C.B. (Part 2) 490-491.]

Section 2036(b), it will be noted, provides that transfers made between March 3, 1931, and June 7, 1932, are to be governed by the Joint Resolution of March 3, 1931, rather than by the amended provision enacted in 1932.

Although the Supreme Court in Burnet v. Northern Trust Co. had taken the unusual step of advising that there was "no question of the constitutional authority of the Congress to impose prospectively a tax with respect to transfers of trusts of the sort here involved," the constitutionality of the Joint Resolution of March 3, 1931, was challenged by a taxpayer in Helvering v. Bullard, 303 U.S. 297 (1938). The Supreme Court did not retreat:

The contention is that the transfer was inter vivos, was presently effective, was irrevocable, was not made in contemplation of, or effective at, death, and that Congress was, therefore, without power to make it the subject of an estate or inheritance tax; that, while the transfer might, by appropriate legislation, have been taxed as a gift, to tax it as in the nature of a testamentary disposition is a denial of due process. The contention is unsound for several reasons. Since Congress may lay an excise upon gifts it is of no significance that the exaction is denominated an estate tax or is found in a statute purporting to levy an estate tax. Moreover, Congress having the right to classify gifts of different sorts might impose an excise at one rate upon a gift without reservation of a life estate and at another rate upon a gift with such reservation. Such a classification would not be arbitrary or unreasonable. A further vindication of the exaction is the authority of Congress to treat as testamentary, transfers with reservation of a power or an interest in the donor. The legislative history of the Joint Resolution . . . demonstrates that the purpose of the legislation was to prevent avoidance of estate taxes. As has been said by the Court of Appeals of New York: "It is true that an ingenious mind may devise other means of avoiding an inheritance tax, but the one commonly used is a transfer with reservation of a life estate." In the Matter of Keeney, 194 N.Y. 281, 287; 87 N.E. 428; affirmed 222 U.S. 525.

We have recently sustained the prospective operation of a provision including in the gross estate property which a decedent has transferred retaining power alone, or in conjunction with any other person, to alter, amend, or revoke. [Helvering v. City Bank Farmers T. Co., supra p. 1158]. We held the purpose of the clause was to prevent avoidance of tax and the measure was reasonably calculated to that end. As applied to a trust created after its enactment the Joint Resolution does not violate the Fifth Amendment. [303 U.S. at 302.]

As the last sentence of the extract from the opinion in the *Bullard* case suggests, the case concerned a trust created after the enactment of the Joint Resolution. On the same day that the *Bullard* case was decided, the Supreme Court held that the Joint Resolution of March 3, 1931, and the 1932 amendment thereof were both intended by Congress to be prospective only. Hassett v. Welch, 303 U.S. 303 (1938).

The Hallock and Church cases. For a few years after 1938, it was widely assumed that pre-1931 transfers were immune from estate tax, even though the

transferor retained a life estate. In 1940, however, the Supreme Court decided Helvering v. Hallock, infra page 1213, which, while it did not pass on the status of pre-1931 life estates, led some judges and commentators to believe that May v. Heiner had been repudiated by implication. In 1948, speculation increased when the Supreme Court ordered a reargument in Commissioner v. Estate of Church, involving a pre-1931 trust with retained life estate. The Treasury had originally contended that the trust was part of the decedent's gross estate, not because of the retained life estate, but because in its view the settlor possessed until his death a reversionary interest in the corpus,* and the case had been argued before the Supreme Court in 1947 on this theory. Reargument of this and another case was ordered in 1948, and counsel were "requested to discuss particularly" a number of questions, several of which were directed to the status of pre-1931 life estates. 68 S. Ct. 1522, 1524 (1947). On reargument, the Treasury again suggested that the *Church* case could be decided upon narrow grounds, without overruling May v. Heiner, but it also argued that that case should be explicitly overruled. The Court, by a divided vote, did so:

> Crucial to the court's holding in May v. Heiner was its finding that no interest in the corpus passed at the settlor's death because legal title had passed from the settlor irrevocably when the trust was executed; for this reason the grantor's reservation of the trust income for his life — one of the chief bundle-of-ownership interests — was held not to bring the transfer within the category of transfers "intended to take effect in . . . enjoyment at . . . his death." This Court had never before so limited the possession or enjoyment section. Thus was formal legal title rather than the substance of a transaction made the sole test of taxability under §811 (c) [1939 Code]. For from the viewpoint of the grantor the significant effect of this transaction was his continued enjoyment and retention of the income until his death; the important consequence to the remaindermen was the postponement of their right to this enjoyment of the income until the grantor's death.
>
> The effect of the court's interpretation of this estate tax section was to permit a person to relieve his estate from the tax by conveying its legal title to trustees whom he selected, with an agreement that they manage the estate during his life, pay to him all income and profits from the property during his life, and deliver it to his chosen beneficiaries at death. Preparation of papers to defeat an estate tax thus became an easy chore for one skilled in the "various niceties of the art of conveyancing." Klein v. United States, 283 U.S. 231, 234. And by this simple method one could, despite the "possession or enjoyment" clause, retain and enjoy all the fruits of his property during life and direct its distribution at death, free from taxes that others less skilled in tax technique would have to pay. Regardless of these facts, May v. Heiner held that such an instrument preserving the beneficial use of one's property during life and providing for its distribution and delivery at death was "not testamentary in character." [335 U.S. 632, 640-641 (1949).]

There were forceful dissents by Justices Burton, Reed, and Frankfurter, resting mainly on the doctrine of stare decisis and the theory that Congress had impliedly accepted May v. Heiner in 1931 and 1932 by overruling it only prospectively.

The statutory aftermath of the Church case. The *Church* case has not had a happy life. Eight months after it was decided, the Treasury Department issued new regulations, announcing that the case would be applied only to the estates of decedents dying after the date of the decision, presumably on the theory that settlors who died before the *Church* case was decided had relied on the vitality of May v. Heiner and would have surrendered their life estates had they anticipated that it would be overruled. A month later, Congress went further. It enacted

* The principles governing the estate tax status of reversionary interests are examined infra page 1209.

the Technical Changes Act of 1949, overruling the *Church* case for settlors dying before January 1, 1950. Settlors still alive were allowed to release or assign their life estates free of gift tax without having the transfer treated as a gift in contemplation of death. Was such "relief" justified? See Bittker, Church and Spiegel, The Legislative Sequel, 59 Yale L.J. 395, 414-418 (1950); Pavenstedt, Congress Deactivates Another Bombshell: The Mitigation of Church and Spiegel, 5 Tax L. Rev. 309 (1950). The 1949 legislation was only the first step. By the Revenue Act of 1950, the terminal date set in the 1949 Act was advanced to January 1, 1951. Finally, in 1953, Congress overruled the *Church* case as to all pre-1931 transfers, regardless of the date of the transferor's death, in response to a recommendation of the House Ways and Means Committee that "the effect of the *Church* decision should be eliminated in all cases to which it was applicable." H.R. Rept. No. 894, 83d Cong., 1st Sess., 1953-2 C.B. 508, 513. The 1953 legislation is embodied in §2036(b), which reflects a return, perhaps more than temporarily, to the status as of 1938, when it was held in Hassett v. Welch that the 1931 and 1932 legislation was prospective only, and when the rule of May v. Heiner controlled pre-1931 transfers.*

ESTATE OF BERGAN v. COMMISSIONER

1 T.C. 543 (1943)

Margaret L. Goggin and the decedent, Sarah A. Bergan, were sisters. The decedent died in 1939. Kate A. Johnson, a third sister, died intestate December 6, 1932, leaving an estate of approximately $500,000, and her only distributees were her two above named sisters. Shortly after Mrs. Johnson's death, Miss Bergan, who was then 74 but in good health, approached Mrs. Goggin, who was five years younger, with the proposition that Mrs. Goggin was to take all of Mrs. Johnson's estate, except $50,000 in bonds which were to be transferred to Miss Bergan, and that there was to be an oral understanding between the two that Miss Bergan would live with Mrs. Goggin for the remainder of Miss Bergan's life and that Mrs. Goggin was to defray all of the living expenses. That proposition was agreed upon by both sisters and was fully executed. The respondent determined that Miss Bergan in 1933 made a transfer of her share of Mrs. Johnson's estate in excess of the $50,000 of bonds, which excess the respondent has determined was subject to both the gift tax and the estate tax. Petitioner by appropriate assignments of error has contested these determinations.

BLACK, Judge: . . .

Is this transfer† of Miss Bergan's share of Mrs. Johnson's estate in excess of the $50,000 block of bonds includible in Miss Bergan's gross estate under [§2036(a)] of the Internal Revenue Code?

We have found as a fact that the transfer was not made in contemplation of death. Cf. United States v. Wells, 283 U.S. 102. Not any of the evidence points in that direction. At the time the transfer was made Miss Bergan was in excellent health for a woman of her age. Her motives for the transfer were that she did not want to be bothered with looking after that much property, but she did

* For problems in determining whether a trust was created before or after 1931 or 1932, for the purpose of applying §2036(b), see Canfield's Estate v. Commissioner, 306 F.2d 1 (2d Cir. 1962); Lowndes and Kramer, Federal Estate and Gift Taxes (2d ed. 1962) §8.5.

If property is added after 1931 to a pre-1931 trust, the additions do not share the immunity of the original property. Pearson v. Commissioner, 36 B.T.A. 5 (1937); Estate of Curie v. Commissioner, 4 T.C. 1175, 1181-1182 (1945).

† It was asserted by the estate that Miss Bergan had "renounced" her interest in Mrs. Johnson's estate, and that a renunciation is not a "transfer" of property under the estate or gift tax statutes. See Brown v. Routzahn, infra page 1270. In an omitted part of the opinion, however, the court held that Miss Bergan's action constituted a "transfer" for tax purposes. — ED.

want to be supported for the remainder of her life and to retain the $50,000 so she would have enough income of her own to make gifts to her church and to charity. She had never owned much property and from the year 1904 she had never paid her living expenses. In other words, she wanted things to go on just about as they had been going, and in the making for [sic] such an arrangement the thought of death was not the impelling cause of the transfer. The transfer was not testamentary in character. All the facts, we think, tend to show that the transfer was associated with life rather than death.

Nor was the transfer intended to take effect in possession or enjoyment at or after Miss Bergan's death. It was intended to take effect and did take effect immediately. Upon the completion of the transfer in 1933, the title vested in Mrs. Goggin, who was then free to use or dispose of the property in any way she desired. The transfer, although made in consideration for support, was unconditional and irrevocable. Miss Bergan could not possibly retrieve the property transferred or any part of it, and Mrs. Goggin could have disposed of all of it immediately if she had so desired.

The respondent strongly contends that in substance Miss Bergan retained for her life the right to the income from the property transferred, and that for this reason the property must be included in Miss Bergan's gross estate under [§2036(a)]. In this connection the respondent points out that the living expenses of Miss Bergan, Mrs. Goggin and her two adult sons, all of which were paid by Mrs. Goggin, were between $25,000 and $30,000 a year, and that, if it took $7,500 a year for Mrs. Goggin to support Miss Bergan, the income from the property transferred (1933 agreed value, $133,662.37) would hardly be sufficient. From this the respondent argues that the result of the agreement between the two sisters was in substance the same as if Miss Bergan had transferred the property in trust with instructions to pay her the income therefrom for life and upon her death to deliver the principal to Mrs. Goggin, citing Tips v. Bass, 21 F.2d 460 (W.D. Tex. 1927), and Updike v. Commissioner, 88 F.2d 807 (8th Cir. 1937), cert. den. 301 U.S. 708.

We think these cases are distinguishable from the instant estate tax proceeding. In both these cases relied upon by the respondent actual trusts were created to secure the annuities, whereas no trust was created in the instant proceeding. Mrs. Goggin was free to use the property transferred to her in any way that she pleased. The title was vested in Mrs. Goggin and not in any trustee. Miss Bergan did not reserve to herself the income from the property transferred. She had entered into a contract with her sister for support and transferred the property in question as consideration for the contract. In the *Tips* case the Government conceded that the real property transferred of the value of $86,000, which was not placed in trust, was not includible in the gross estate. Although the entire property in the *Updike* case was not placed in trust, the entire transfer in that case was made in contemplation of death, a fact which clearly distinguishes that case from the instant proceeding. In other words, the property transferred in the *Updike* case was included in the gross estate because the transfer was made in contemplation of death and not because the decedent there had in effect reserved to himself for life the income from the property transferred. . . . The *Updike* case is therefore not controlling. . . . On this issue we sustain petitioner.

We shall now consider the question whether any part of Miss Bergan's share of Mrs. Johnson's estate in excess of the $50,000 block of bonds is taxable as a gift made in 1933. . . .

In deciding the estate tax question we held that Miss Bergan made a "transfer" during the year 1933 of her share of Mrs. Johnson's estate in excess of the $50,000 block of bonds in consideration for Mrs. Goggin's promise to support Miss Bergan

for the remainder of Miss Bergan's life. The parties agree that in 1933 the value of the property thus transferred by Miss Bergan was the amount of $133,662.37. Petitioner contends that the transfer was for an adequate and full consideration in money or money's worth and that there was, therefore, no gift. In the alternative, petitioner contends that if the transfer was for less than an adequate and full consideration, the minimum value of such consideration . . . would be $38,880.15, and that only the difference between $133,662.37 and $38,880.15 should be deemed a gift under [§2512(b)]. The respondent contends that the transfer was for less than an adequate and full consideration; that petitioner has failed to prove the value of the consideration, namely, Mrs. Goggin's promise to support Miss Bergan for the remainder of Miss Bergan's life; and that, therefore, the entire value of the property transferred ($133,662.37) should be deemed a gift under [§2512(b)].

The Committee on Ways and Means, in its report accompanying the Revenue Bill of 1932, referred to [§2512(b)] as follows:

> Since the tax is designed to reach all transfers to the extent that they are donative, and to exclude any consideration not reducible to money or money's worth, it is provided in this section that where the transfer is made for less than an adequate and full consideration in money or money's worth, the excess in value of the property transferred over such consideration shall be deemed a gift. For example, if A sells property worth $10,000 to B for $1,000, there is a gift of $9,000. (Cumulative Bulletin 1939-1, Part 2, p. 477.)

. . . In the instant gift tax proceeding there was a valid consideration for the transfer in question, namely, Mrs. Goggin's promise to support Miss Bergan for the remainder of Miss Bergan's life, but it was less than an adequate and full consideration for the property which was transferred. Is that consideration reducible to a money value? We think it is. Mrs. Goggin was to support Miss Bergan according to the standard then being enjoyed by the four adults which was at a cost of between $25,000 and $30,000 a year, or an average of between $6,250 and $7,500 for each adult. We adopt the lower figure in view of the insufficiency of the evidence to adequately establish a higher figure than that. We think such a consideration may be valued in the same way that an annuity of $6,250 for Miss Bergan's life would be valued. At the time of the transfer in 1933 Miss Bergan was 74 years of age. According to column 2 of table A mentioned in [Regs. 108 §86.19], the present value of $1 due at the end of each year during the life of a person 74 years of age is $5.18402, or $32,400.13 for an annuity of $6,250.* This is the same method of computation as petitioner used in arriving at the figures of $38,880.15 as being the value of Mrs. Goggin's agreement to support and maintain Miss Bergan during the remainder of her life. The difference in our figure and that arrived at by petitioner is that we use a figure of $6,250 as the cost of annual support and maintenance for Miss Bergan, whereas petitioner used $7,500 as such annual figure. We find, therefore, that Miss Bergan transferred property of the value of $133,662.37 for an equivalent in money of $32,400.13, and, under [§2512(b)], we hold that the excess of the value of the property transferred over the value of the consideration, or $101,262.24, shall be deemed a gift and shall be included in computing the amount of gifts made by Miss Bergan during the calendar year 1933. . . .

Decisions will be entered under Rule 50.

* This table was employed for gifts made prior to January 1, 1952, see Regs. 108 §86.19(g), but a revised table computed on the basis of interest at 3½ per cent instead of 4 per cent is in effect for current gifts. Regs. §25.2512-5. — Ed.

BECKLENBERG'S ESTATE v. COMMISSIONER

273 F.2d 297 (7th Cir. 1959)

Before SCHNACKENBERG, PARKINSON and KNOCH, Circuit Judges.

KNOCH, Circuit Judge.

This matter comes to us on petition for review of a decision of the Tax Court of the United States, respecting the gross estate of Maria Becklenberg, deceased, for federal estate tax.

On March 17, 1934, decedent joined with her husband and son in establishing a Trust, to which each contributed assets then valued as follows:

Decedent	$379,166.37	26.78%
Fred Becklenberg, Sr.	293,499.32	20.73%
Fred Becklenberg, Jr.	743,186.56	52.49%

No separate accounts were maintained. Several properties contributed by decedent were sold. No distribution was made. On August 12, 1938, the Trust was revoked and its assets transferred to a new Trust. This 1938 Trust provided for liquidation as expeditiously as possible and for purchase of annuities for specified members of the family, including one for decedent in the amount of $10,000 per year for life. Until purchase of the annuities, sums might be paid to the beneficiaries, not to exceed $10,000 annually in the case of decedent. No annuities were purchased during decedent's life. Certain payments were made to the beneficiaries, including payments not in excess of $10,000 annually to decedent.

The taxpayer argues that decedent retained no right to income; that she, in effect, bought a right to an annuity; that the payments actually made to her (out of income of the Trust, though not out of income of the specific assets she contributed to the Trust) could have been terminated at any time by purchase of an annuity for her. . . .

> The indisputable fact is that decedent received the right to annual payments of $10,000 from the 1938 trust until the trust purchased the annuity policy that would produce $10,000 annual payments from some insurance company. This is the way all of the donors construed the instrument and their interpretation was confirmed by the State Court. This is made abundantly clear by the claim for back payments made by decedent which was settled by the deed, the construction alleged in the interpretation suit, and the court decree, and the actual payment to decedent of $10,000 annually until she died. There is no merit in petitioner's argument that all decedent obtained under the 1938 trust was the right to compel the trustees to purchase an annuity that would give her annual payments of $10,000.00. The argument is foreclosed by the interpretation of the 1938 trust instrument by the donors and the Illinois Court.

The Superior Court of Cook County, Illinois, in Case Gen. No. 43-S-7734, construed the 1938 Trust in a suit brought in 1943 by Fred Becklenberg, Sr., as Trust Manager, and Fred Becklenberg, Jr., then sole Trustee. In their Complaint, they stated that, in their interpretation of the 1938 Trust, decedent was entitled to annual payments of $10,000 until the annuity was purchased.

The Superior Court approved the actions, accounts, and interpretation of Fred Becklenberg, Sr., and Fred Becklenberg, Jr., and decreed (inter alia) that wide discretion was vested in the Trustee and the Trust Manager as to when, or whether, the annuities should be purchased; that, in view of changed conditions and circumstances, distribution to certain named members of the Becklenberg family need not be restricted to the purchase of life insurance annuities, but that the 1938 Trust Agreement authorized distribution to them, of income, principal

or proceeds, "having due regard, however, to the preservation of sufficient of the principal or corpus of said Trust Estate to assure annual payments provided for under said Trust Agreement" including the $10,000 annual payment to decedent.

The Superior Court further provided, in connection with such distribution for certification that "the remainder of the principal or corpus of said Trust Estate is amply sufficient to assure the payments provided . . . to be made" including that to decedent. During the years 1940 through 1951, decedent did receive approximately $10,000 annually.

The Tax Court held that decedent had retained the right to receive annual distributions of $10,000 from the income of the 1938 Trust and that, therefore, the amount of corpus necessary to produce such income was includible in her gross estate for purposes of the federal estate tax. The Tax Court capitalized the annual payment of $10,000 by the average rate of return of income on the trust property (which the Tax Court found to be 0.03455%) or $289,855.07, to find the amount includible in the gross estate.

We agree that decedent (under the interpretation made by the Superior Court of Cook County) retained a right to receive $10,000 annually, by way of annuity or by distribution from the Trust. Although this sum was, in fact, paid to decedent out of the income of the Trust for most years, it does not appear that the payments were restricted to income. In 1942, in settling decedent's claim for deficiencies in payments previously made to her, a portion of the corpus was distributed to decedent with approval of the Superior Court. Under the 1938 Trust, payments might be made from principal. Under the construction of the Superior Court, decedent would have had to be paid $10,000 annually, even though the Trust produced an income of less than $10,000, and it had been necessary to invade corpus. Unlike the Tax Court, we believe that the Trust had an obligation to pay decedent $10,000 annually, and that her right to receive it was not limited to the property transferred by her or the income therefrom.

The Tax Court has computed the amount of the Trust assets to be includible in decedent's gross estate as though the Trust here required decedent to be paid $10,000 out of taxable income, whereas decedent could have been paid out of principal. She retained the right to receive $10,000 annually for life; she did receive $10,000 annually for life. Thus at her death, there was nothing left to be included in her gross estate.

The case before us is clearly distinguishable from the cases cited by the Commissioner. In both Estate of Moreno v. Commissioner, 8 Cir., 1958, 260 F.2d 389, and Toeller's Estate v. Commissioner, 7 Cir., 1948, 165 F.2d 665, the Trust provided for distribution of all income with a further provision for invading the corpus for specified emergencies.

Unlike the Commissioner and the Tax Court, as indicated above, we do see similarities between the case before us and the line of cases mentioned in Fidelity-Philadelphia Trust Co. v. Smith [infra page 1257, note 4].

In Estate of McNichol v. Commissioner, 3 Cir., 1959, 265 F.2d 667, and other cases like it, cited by the Commissioner, the decedent purported to convey income-producing property without reservation, but actually did make contemporaneous oral agreements (or other arrangements) under which he was to receive the income, and under which he did, in fact, receive the income until his death.

Because of the basis on which this case has been determined, we do not reach various other questions respecting such matters as, for example, valuation of assets which decedent transferred to the Trust, or computation of the amount of corpus which would have been needed to produce an income of $10,000 annually, had decedent retained the right to receive payments of $10,000 annually, limited to income of the Trust.

Reversed.

NOTE

1. *"The income from the property."* If A owns one thousand shares of A.T. & T. stock, on which the annual dividend for many years has been $9.00 per share, and transfers these shares in trust, reserving for himself the income for life, the value of the shares at the date of his death will be includible in his gross estate under §2036. Does the statute produce a different estate tax result if he transfers the shares to his children and they agree: (a) to hold the securities for his life and to pay him the dividends therefrom; (b) to pay him $9000 per year for his life whether they hold the securities or not; or (c) to pay him each year, whether they hold the securities or not, an amount equal to the dividends declared by the American Telephone and Telegraph Company on one thousand shares?

Would the estate tax effect of agreement (a) be affected if the children pledged the securities with A or with a third person to insure compliance with their agreement? If any of these three cases is treated differently under the statute than a transfer of the securities in trust with reservation of income for life, is there any reason of policy for the difference? See Greene v. United States, 237 F.2d 848 (7th Cir. 1956) (transfer of property to donee on latter's agreement to pay the income to donor, but not less than $1500 per year: held. §2036 embraces transfer by trust "or otherwise," including this transaction); Rev. Rul. 55-378, 1955-1 C.B. 447, involving a trust of $100,000 created by the grantor for the benefit of his children, under which he reserved the right to withdraw $2500 a year or all of his living expenses: "The decedent did not transfer the property to his children absolutely in consideration of their agreement to pay him $2500 a year or all of his living expenses but instead he transferred the property into a trust account reserving the right to receive $2500 a year or all of his living expenses out of the transferred property. Accordingly, it is held that the transfer was not a bona fide sale for an adequate consideration in money or money's worth and is includible in decedent's gross estate" under §2036(a). Is the ruling based on a distinction without a difference? See Fidelity-Philadelphia Trust Co. v. Smith, infra page 1257, note 4.

For the income tax consequences of private annuity arrangements, see Commissioner v. Kann's Estate, supra page 461; and note that the dissenting judge viewed the transaction as a substitute for a testamentary disposition.

2. *Retention of fixed amount on a transfer of property.* Suppose A transfers $100,000 in trust, reserving the right to receive the first $25,000 of income produced by the transferred property. If A dies before he has received $25,000, is the corpus includible in his estate on the ground that he retained the income for a "period which does not in fact end before his death"? Would it make a difference whether, having regard to his life expectancy and the trust's yield, the $25,000 was likely to be paid during his life or not?

Suppose he reserved the right to receive the income for 3 years and died during that period. Would inclusion depend upon whether 3 years was more or less than his life expectancy? The pre-1954 Regulations provided that §2036 (a) was applicable if the decedent reserved the income of property "for such a period as to evidence his intention that it should extend at least for the duration of his life and his death occurs before the expiration of such period." Regs. 105 §81.18. This provision does not appear in §20.2036-1 of the current Regulations. See Estate of Fry v. Commissioner, 9 T.C. 503 (1947); cf. Estate of Hays v. Commissioner, 181 F.2d 169 (5th Cir. 1950); see also the 1932 committee report on the phrase "for any period which does not in fact end before his death," supra page 1180.

3. *Purchase of annuity as substitute for retention of life estate.* If A transfers $100,000 into a trust, reserving the income for life, with remainder to his children, §2036 will require the trust property to be included in his gross estate, and any part of the income that he may have saved will be includible under §2033. If he spends part of his $100,000 for an annuity, from which he will receive $5000 annually for his life, and puts the balance of the $100,000 in trust to accumulate the income for his life and to pay the corpus and accumulated income to his children on his death, his gross estate will include only such amounts as he may have saved out of the annual receipts from his annuity. (If he is concerned about the possibility that the fixed income from the annuity will

turn out to be less, because of inflation, than might have been earned by investing the original $100,000, he may be able to restore the balance by buying a variable annuity.) Should the two transactions have the same estate tax results? See Fidelity-Philadelphia Trust Co. v. Smith, infra page 1255.

4. *Distributions of income to grantor in trustee's discretion.* Boardman's Estate v. Commissioner, 20 T.C. 871 (1953), involved a transfer of property in trust under which the trustees were to make such distributions to the grantor from income and principal as they "deem necessary for her comfort, support and/or happiness." The court found that the trust instrument "offered no basis upon which the trustees could have withheld any of the income of the trust which the decedent might have desired during her life" and held that in these circumstances she retained the right to the income for life. The principal purpose of the trust was to support the decedent, the court said that the trustees "could not resist her demand for the income," and she in fact did receive the income therefrom during her life. Would the result have been different if the primary purpose of the trust had been to provide an income for life for the grantor's parents, but the trustees were given the power to make such distributions to the grantor as they "deem necessary for her comfort, support and/or happiness"? See Blunt v. Kelly, supra page 1164.

If the decedent created a trust under which the trustee had unfettered discretion to distribute income or corpus to the decedent, can the trust property be included in the gross estate if under state law the decedent's creditors could have levied on it? See Uhl's Estate v. Commissioner, 241 F.2d 867 (7th Cir. 1957); Zissman, Problem Areas in the Estate Tax, 41 Taxes 875, 881-884 (1963).

COMMISSIONER v. DWIGHT'S ESTATE

205 F.2d 298 (2d Cir. 1953), cert. denied, 346 U.S. 871

Before L. HAND, AUGUSTUS N. HAND and FRANK, Circuit Judges.

AUGUSTUS N. HAND, Circuit Judge.

The Tax Court, with four judges dissenting, held that there is an overpayment of the estate tax in the amount of $173,353.28 since the Commissioner had erred in including the decedent's gross estate the value of two trusts established by him during his lifetime. 17 T.C. 1317. The findings of fact by the Tax Court may be summarized as follows:

The decedent, Arthur S. Dwight, who at the time of his death on April 1, 1946, was a resident of the State of New York, on March 15, 1930, married Anne Howard Chapin who had had six children by a previous marriage. All of the children were adults at that time with the exception of one who was seventeen years of age. Until decedent's death he and his wife lived together as husband and wife at their principal residence in Great Neck, Long Island, except for winters which were spent at their Florida home.

On December 21, 1931, the decedent established a trust of $170,000, which he increased by $25,000 in 1934, for the benefit of his wife and her six children. The corporate trustee was to distribute 40% of the income to the decedent's wife and 10% to each of her children "for their support and maintenance," but the trustee was "not responsible for the use or application of such income." The trust was to terminate at the death of the survivor of the decedent and his wife, when the principal was to be distributed to the children or their issue. Provision was made for the allocation of the income share of any beneficiary who died prior to the termination.

On August 15, 1935, the decedent made a transfer, on which a federal gift tax was assessed and paid, of $200,000 in trust. The trust indenture provided that the decedent's wife would receive the income during her lifetime "for her support and maintenance, without power of anticipation." Upon the death of the income-beneficiary the trust was to terminate and the principal was to be dis-

tributed in equal shares to eight named persons or their issue. A letter written before, but not delivered until after, the execution of the trust indenture shows that the decedent's motive for establishing this trust was to provide his wife with income to meet the living and hospital expenses of her two adult invalid daughters and to meet the annual maintenance expense of the winter home in Florida which he had previously given to her. At all times during their marriage the decedent paid the expenses of running the family home in Great Neck, Long Island; after the establishment of the first trust the decedent's wife paid for her own clothing and other personal needs.

The Commissioner contends that 40% of the value of the first trust, and the entire value of the second trust are includible in the decedent's gross estate by reason of [§2036(a)], since the income was to be used to discharge his legal obligation to support his wife. (The Commissioner has conceded that New York law imposed no legal obligation upon the decedent to support his surviving stepchildren who were all adults at the time of his death, . . . and therefore has limited the appeal to 40% of the value of the first trust. . . .) The majority of the Tax Court held that the decedent did not retain the enjoyment of the income for life since he did not reserve to himself an enforceable right to have the trust income applied towards his wife's support.

Although a husband is of course able to make a gift to his wife without affecting his duty to support her, . . . we think that this was clearly not the case here as to the first trust. The decedent was under a legal duty to support his wife under the New York law . . . and the trust instrument provided that the income was for her "support and maintenance." We agree with the dissenting opinion in the Tax Court that this provision was not meaningless, and think that Helvering v. Mercantile-Commerce Bank & Trust Co., 8 Cir., 111 F.2d 224, certiorari denied 310 U.S. 654, is not distinguishable on the ground that there the settlor reserved an "enforceable right" to have the income applied toward his wife's support in the trust instrument. See also Helfrich's Estate v. Commissioner, 7 Cir., 143 F.2d 43; Hooper v. Commissioner, 41 B.T.A. 114. Having furnished his wife with this income the husband had in part at least discharged his legal obligation of supporting her. . . . The existence of the income from the trust would certainly have been a pro tanto defense in any suit for support brought by his wife. We do not see how the absence of a provision in the trust for rigid supervision of the wife's expenditures in any way affects this reasoning. Nor do we see why it should matter that the decedent's full obligation to support may not have been discharged. . . . Thus, since part of the income of the first trust was, in the language of the regulations, "to be applied toward the discharge of a legal obligation of the decedent" [Regs. §20.2036-1(b)(2)], we hold that he retained the enjoyment of that income and accordingly 40% of the value of the trust is includible in his gross estate.

The second trust presents a more difficult problem. Although the trust instrument also provided that the income was to be paid for the "support and maintenance" of the decedent's wife, his explanatory letter indicates that his intent was to furnish her with sufficient income to care for her two invalid daughters and to pay for the maintenance of the Florida home. It is asserted that neither item was within the decedent's legal duty to provide for his wife, and that therefore he did not retain the enjoyment of the income within the meaning of [§2036(a)]. The taxpayer justifies the admission of this letter into evidence by the Tax Court over the objection of the Commissioner on the ground that the parol evidence rule is inapplicable in a controversy involving a stranger to the integrated trust indenture. . . . However, this is too broad a statement of the rule, for a stranger to an instrument may not in every case vary its terms by parol evi-

dence. . . . Facts recited in an integrated agreement may of course be shown to be untrue even by the parties themselves. Restatement, Contracts, §244. Moreover, proof of fraud against the rights of third parties may be received, even though such evidence would perhaps be inadmissible in a suit between the parties themselves. 3 Williston, Contracts, §647 (Rev. ed.); 9 Wigmore, Evidence §2446 (3d ed.). But here there is no question of fraud on the rights of the tax collector. And where the issue in dispute is the legal obligation of the parties to the agreement, the writing must be taken as the full expression of that legal relationship (assuming that the parties intended the writing to be an integration of the complete contract.) 3 Corbin, Contracts, §596; 3 Williston, Contracts, §647 (Rev. ed.); 9 Wigmore, Evidence, §2446 (3d ed.).

The trust indenture here created a legal obligation on the part of the trustee to pay the income to the settlor's wife for her "support and maintenance." Although strictly speaking the wife was not a party to the agreement, it is to her that the obligation is owed and only she may enforce it. Restatement, Trusts, §200; 2 Scott, Trusts, §200. Her rights are entirely dependent on the legal effect of the trust indenture. Consequently, in a suit by the wife against her husband for support the parol evidence rule would have prevented her from showing that the income was not to be used for her "support and maintenance" and the existence of the second trust would have been a pro tanto defense for the husband. Therefore, since the income was to be used to discharge the decedent's legal obligation, he retained its enjoyment and use, and under [§2036(a)] the principal of the trust is includible in his gross estate.

The respondent has presented no proof that the decedent's obligation to support would not have at least equalled the amount of the income payable to his wife from these two trusts. The taxpayer had the burden of proof upon this question, . . . and in the light of his evident wealth we hold that the decedent's own estimation in the provisions of these trusts of the extent of his obligation to provide for his wife did not exceed what the law would have required of him. Therefore, 40% of the value of the first trust, and the entire value of the second trust are includible in his gross estate.

Accordingly, the judgment is reversed and the case remanded to the Tax Court for a recomputation of the decedent's estate tax in accordance with the terms of this opinion.

L. HAND, Circuit Judge (dissenting in part).

I altogether agree as to the first trust, for it seems fair to me to hold the taxpayers to their burden of proof to show that forty per cent of its income would not have been more than a reasonable allowance to the wife for her "support and maintenance." As to the second trust, if we were to affirm the order, I think I should also agree that the taxpayers should have shown that the income from it, when added to forty per cent of the income from the first trust, was no more than a New York court would have allowed to the decedent's wife for "support and maintenance." But we are reversing the order and are sending the cause back to the Tax Court to recompute the tax; and I do not see what warrant we have for denying to the taxpayers the privilege of carrying the burden of so proving, if they can, now that it has become vital. The only reason for such a denial must be that they failed to do so before, when it turned out to be unnecessary; and that appears to me unduly severe.

The liability of a husband for the "support and maintenance" of his wife depends, certainly in cases of divorce, upon his resources and the spouses' customary mode of life. Only to that extent is he liable, and his liability measures the extent of the tax in the case at bar. It is a very fluid issue at best, and if the taxpayers wish to contest it, I would not foreclose them. I agree that in an action

on the deed the husband's letter could not be used to modify the obligation to devote the income of the second trust to the wife's "support and maintenance"; but what he gave does not measure what the courts would allow her; and the letter would certainly be competent evidence of his opinion as to what was a suitable allowance. Moreover, I rather think that his opinion would be relevant in determining the amount of his legal liability for "support and maintenance," though that is not so plain. In any event, I need not pass on that, for my view is not to prevail.

NOTE

1. *Support trusts.* According to Regs. §20.2036-1(b)(2), §2036 applies if the income from the transferred property "is to be applied (or an enforceable right exists to cause it to be applied) toward a legal obligation of the decedent, or otherwise for his pecuniary benefit." Compare §677(b), providing that the income of a "support" trust is not to be taxed as income of the grantor "merely because such income in the discretion of another person, the trustee, or the grantor acting as trustee or co-trustee, may be applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain, except to the extent that such income is so applied or distributed." This provision was enacted after it was held in Helvering v. Stuart, 317 U.S. 154 (1942), that if a trustee had the power to use the income of a trust for the support of the grantor's minor children, the income came within the language of what is now §677(a)(1) and (2). Supra page 371. May a support trust be included in the gross estate even though the income was not taxed to the decedent during his lifetime, or be excluded from the estate even though the income was taxed to the decedent? Should different tests be applied?

On the problem of determining whether a trust's income discharges the grantor's support obligation or not, see Lee's Estate v. Commissioner, 33 T.C. 1064 (1960), and cases there cited.

Note the concession by the government regarding the income payable to adult stepchildren under the first trust. If they were minors when the trust was created, but reached their majority before the settlor's death, was the income reserved by him for a "period not ascertainable without reference to his death"?

If a gift to the decedent's wife or minor children became part of the donee's "independent resources" to be taken into account under local law in determining the amount of his support obligation in later years, does the income from the property serve to discharge his legal obligation — or did the gift itself eliminate any such obligation (or reduce it pro tanto)?

If a trust for the support of the decedent's wife or minor children is included in his gross estate under §2036, can any part of the corpus be excluded on the ground that the transfer was "a bona fide sale for an adequate and full consideration in money or money's worth"? See E.T. 19, supra page 1033; McKeon's Estate v. Commissioner, 25 T.C. 697, 705-707 (1956) (E.T. 19 not cited).

See Note, Federal Tax Aspects of the Obligation to Support, 74 Harv. L. Rev. 1191, 1217-1220 (1961).

2. *Gift tax aspects of support trusts.* There was no gift tax when the 1931 trust in the *Dwight's Estate* case was created. Had it been created after 1932, would a federal gift tax be due? Gift tax was paid, the court states, on the 1935 trust. Should the value of the wife's income interest have been excluded in computing the grantor's gift tax liability? See page 1036 supra.

3. *Alimony trusts.* See §682, providing that a wife who is divorced or legally separated from her husband must report the income of a trust created by the husband for her support. Is the corpus of such a trust includible in the husband's gross estate under §2036 even though the wife is taxable on the income? Can it be excluded from the husband's estate under the parenthetical clause relating to a bona fide sale? See E.T. 19, supra page 1033; Past v. United States, 13 A.F.T.R.2d ¶146,505 (S.D. Cal. 1963) (property settlement). If the creation of such a trust terminates the husband's duty to support

his wife under local law, is §2036 inapplicable? See discussion in Helvering v. Fuller, 310 U.S. 69 (1940), and Helvering v. Fitch, 309 U.S. 149 (1940), of the possibility of thus terminating the husband's obligation.

If the income of an alimony trust is to be paid to the ex-wife even if she remarries, and this event occurs before the grantor's death, has the income been reserved by him "for his life or for any period not ascertainable without reference to his death"?

4. *Contradicting the instrument.* In *Dwight's Estate,* the court held that the parol evidence rule precluded evidence that the grantor did not intend to discharge his duty of support by establishing the second trust. What if the shoe is on the other foot: the instrument contains no reservation of the income, but the government offers evidence that the income was in fact received by the decedent and asks the court to infer from this fact that there was a secret arrangement between him and the trustee amounting to a reservation of the income? In Skinner's Estate v. United States, 316 F.2d 517 (3d Cir. 1963), a determination by the District Court that there was such an understanding was upheld, although the court indicated that it was "breaking new and perhaps dangerous ground" by placing "a heavy burden upon the estate of a settlor of a discretionary trust to avoid the inference of secret prearrangement with the trustee when the settlor has in fact received all income during his life." See also McNichol's Estate v. Commissioner, 265 F.2d 667 (3d Cir. 1959), cert. denied, 361 U.S. 829 (accord).

Note that the decedent in *Dwight's Estate* gave his wife their Florida home (in 1934, according to the Tax Court, 17 T.C. at 1320). If he expected to spend winters with her in Florida after after the gift, did he retain "possession or enjoyment of . . . the property" even though the transfer was outright? See Burr's Estate v. Commissioner, ¶45,364 P-H Memo T.C. (summer home given to wife not includible in husband's gross estate; his continued occupancy "was at the sufference of his wife and not because of any rights he possessed in the property").

On the possibility that the grantor may be treated as having retained "possession or enjoyment" of the stock of a one-man or closely held corporation if he continues to own a majority interest and to receive a salary as its principal officer, see Hofford v. Commissioner, 4 T.C. 790 (1945); Holland v. Commissioner, 47 B.T.A. 807 (1942) and 1 T.C. 564 (1943).

5. *Reservation of contingent life estate.* If the grantor of a trust reserves a contingent life estate by providing that the income shall be paid to his wife for her life, then to himself if he survives her, with remainder to the children, and he survives his wife, the property is clearly includible in his gross estate under §2036(a)(1) because he has reserved the income for a "period which does not in fact end before his death." If he predeceases his wife, however, so that his contingent life estate does not ripen into present enjoyment, is the property includible? Although §2036's phrase "for any period not ascertainable without reference to his death" seems to describe the transfer, it has been argued that the explicit reference in the House committee report on the 1932 amendment to the Joint Resolution of 1931 (supra p. 1179) to the taxability of a contingent life estate where the settlor survives the primary life tenant implies by negative inference that the tax does not apply if he does not survive. Since May v. Heiner itself involved a contingent life estate and a transferor who apparently did not survive the primary life tenant, however, the Court of Appeals for the Second Circuit has refused to accept this argument, pointing out that it would produce "the astonishing result" that the Joint Resolution of 1931 "failed of its intended purpose" of reversing May v. Heiner. Marks v. Higgins, 213 F.2d 884 (2d Cir. 1954); see also Commissioner v. Arents' Estate, 297 F.2d 894 (2d Cir. 1962), cert. denied, 369 U.S. 848; Hubbard's Estate v. Commissioner, 250 F.2d 492 (5th Cir. 1957) (contra).

6. *Reservation of life estate on conveyance of jointly held or community property.* In Glaser v. United States, 306 F.2d 57 (7th Cir. 1962), the decedent and his wife conveyed property which they owned as tenants by the entirety to their children, reserving a life estate for themselves jointly and for the survivor. Because the decedent had paid the entire consideration, so that the full value of the property would have been included in his gross estate under §2040 had the tenancy continued until his death, the government argued that the decedent's contingent life estate required the full value to be included under §2036. The court held that he had transferred only one half of the property, with the

result that only one half was included under §2036. See also Borner's Estate v. Commissioner, 25 T.C. 584 (1955); Hornor's Estate v. Commissioner, 305 F.2d 769 (3d Cir. 1962).

For a similar transaction involving community property, see Vardell's Estate v. Commissioner, 307 F.2d 688 (5th Cir. 1962) (decedent's husband had provided by will that his one half of their community property would be put in trust with income to her and remainder to children provided she elected similar treatment for her one half; held, one judge dissenting, her share of the community property, less the value of the life estate received by her, is includible in her gross estate).

See Comment, Problems of Estate and Gift Taxation of Joint Ownership Interests, 10 U.C.L.A.L. Rev. 1205, 1213-1222 (1963).

STATE STREET TRUST CO. v. UNITED STATES

263 F.2d 635 (1st Cir. 1959)

Before MAGRUDER, Chief Judge, and WOODBURY and HARTIGAN, Circuit Judges.

WOODBURY, Circuit Judge.

This is an appeal from a judgment entered in a civil action brought . . . by the executors of the estate of Milton L. Cushing to recover an asserted overpayment of estate taxes resulting primarily from the Commissioner's inclusion in the decedent's gross estate of the value of three inter vivos trusts of which the decedent was in effect the settlor and at the time of his death a co-trustee. After trial without a jury the District Court, upon its findings of fact and conclusions of law, held that the value of the three trusts were properly includible in the decedent's gross estate and that the Commissioner had property disallowed certain claimed deductions for executor's commissions and legal fees. But it held that the estate was entitled to a deduction of $2,000 as the reasonable expense of the prosecution of this action. The court below therefore entered judgment for the plaintiffs in the amount of $567.20, with interest, and the plaintiffs thereupon took this appeal.

It is agreed that the only question now presented is whether the discretionary powers set out in the three trusts render the trust property includible in the decedent's gross estate under [§§2036(a)(2) and 2038(a)(1)].

There is no substantial dispute over the facts. They are as follows:

In 1925 Milton L. Cushing established three spendthrift trusts for the benefit of three of his children wherein he named himself and a bank as co-trustees. These trusts were irrevocable and there was no express reservation of power to alter, amend or revoke, but the settlor reserved the power to terminate them and cause the properties held in the trusts to be distributed to the respective beneficiaries. In 1949 the decedent exercised this power with respect to each of the trusts, but he did so upon the condition that the respective beneficiaries immediately establish new trusts of the property covered in each of the old ones. The beneficiaries did so and the court below held and the appellants agree that in this situation the decedent must be treated as the settlor. Thus, although the trust instruments in issue are written as though the respective beneficiaries are the settlors, it is admitted that actually the decedent was the settlor, and therefore that the powers given to the trustees in these trusts must be regarded as having been reserved by the decedent himself.

The District Court found that the 1949 trusts were created primarily to carry out the decedent's original purpose to assure the maintenance of his three children. More specifically, that court found that because of a possibility of reverter in the 1925 trusts the decedent was concerned about the possible effect of Estate of Spiegel v. Commissioner, 1949, 335 U.S. 701, which held an estate taxable

under §811(c) [1939 Code] for the value of an inter vivos trust wherein there was the possibility of a reversion to the settlor should he outlive his children and grandchildren. But in addition the court found that the decedent [160 F. Supp. 878] "also wished to make some changes in the very rigid and restrictive investment provisions and, since two of the beneficiaries had been married and divorced, he thought that the terms of the original trusts were no longer adequate." [1]

The three 1949 trusts are substantially identical, and they are similar to the 1925 trusts in that they contain no express reservation of power to alter or amend. They differ from the earlier trusts, however, in that they are expressly irrevocable and there is no reservation of power to terminate them and cause distribution of the trust properties to the beneficiaries. The decedent and Old Colony Trust Company are made co-trustees and in the first paragraph of each of these trusts, the trustees are directed to pay the net income of the trust funds to the life beneficiary named therein, "quarterly, or oftener if practicable," and in addition from time to time to pay to that beneficiary or for his benefit, in their "sole and uncontrolled discretion," such portion or portions of the principal as the trustees "may deem necessary or advisable" for the beneficiaries' "comfortable maintenance and/or support." The District Court held that under Massachusetts law the trustees' power to invade capital for the beneficiaries' "comfortable maintenance and/or support," though broad, nevertheless created determinable rights in the beneficiaries which could be enforced in a court of equity. It therefore concluded that under the rule applied in Jennings v. Smith, 2 Cir., 1947, 161 F.2d 74, the corpora of the trusts were not made taxable to the settlor's estate under [§§2036 or 2038], by reason of the trustees' power to invade principal for the support of the life beneficiaries. The government does not urge error in this holding as ground for sustaining the judgment below.

The problem on this appeal arises from the provisions of the third paragraph of the trusts wherein the trustees are clothed with broad powers with respect to the investments open to them and their management of the assets of the trusts. The language of this paragraph which the court below found to be so broad that the trustees were not limited in the exercise of their fiduciary duties by any determinable standard, so that the rule of the Jennings case does not apply to prevent inclusion of the corpora of the trusts in the deceased settlor's gross estate, and on which the government relies to sustain that holding, is as follows:

> In addition to and not in limitation of all common law and statutory authority, the Trustees shall have power . . . to exchange property for other property; . . . to retain and invest and reinvest in securities or properties although of a kind or in an amount which ordinarily would not be considered suitable for a trust investment, including, but without restriction, investments that yield a high rate of income or no income at all and wasting investments, intending hereby to authorize the Trustees to act in such manner as it is believed by them to be for the best interests of the Trust Fund, regarding it as a whole, even though particular investments might not otherwise be proper; . . . to determine what shall be charged or credited to income and what to principal notwithstanding any determination by the courts and specifically, but without limitation, to make such determination in regard to stock and cash dividends, rights, and all other receipts in respect of the ownership of stock and to decide whether or not to make deductions from income for depreciation, amortization or waste and in what amount; . . . and generally to do all things in relation to the Trust Fund which I, the Donor, could do if living and the Trust had not been executed.

[1] Accordingly, although the decedent died nine months after the creation of the 1949 trusts, the court below rejected the contention made by the government in that court, but not suggested here as a possible ground for affirmance, that the transfers to those trusts were made by the settlor in contemplation of his death.

In conclusion the third paragraph of the trusts provides: "All such acts and decisions made by the Trustees in good faith shall be conclusive on all parties at interest and my Trustees shall be liable only for their own wilful acts or defaults, but in no case for acts in error of judgment."

The case is very close, but we agree with the result reached by the District Court.

It is true that it is not at all unusual to clothe trustees with power to invest trust assets in securities other than so-called "legals." And it is also true that it is far from uncommon to provide that trustees shall have the power in their discretion to allocate accretions to the property they hold in trust to principal or to income, at least when there is no settled rule of law to apply and proper allocation is open to honest doubt. Certainly in the exercise of one or both of these powers trustees can to some extent affect the interests of the various beneficiaries. Indeed, even in a trust wherein investment is limited to "legals," a trustee can effect some shifting of benefits between life beneficiaries and remaindermen by his choice of investment with respect to rate of income return or growth potential. But we would hardly suppose that in the ordinary case inclusion of one or both of the above provisions in a trust instrument would be a crucial factor in deciding whether or not the corpus of the trust should be included in a decedent's estate.

This, however, is not an ordinary case. Literally, the trustees have power to exchange trust property for other property without reference to the value of the properties involved in the exchange. And literally, they have power to invest the trust assets in securities yielding either a high rate of income or no income at all, and even in wasting investments, and they have power to invest trust assets in these categories in whatever amounts they choose without limitation with respect to the percentage of the trust corpus invested in any one of them. Moreover, the trustees' discretionary power to allocate trust assets to corpus or income is not limited to situations where the law is unsettled and there is honest doubt whether a given accretion or receipt should be classified as capital or income. See Doty v. Commissioner, 1 Cir., 1945, 148 F.2d 503, 507, and Scott on Trusts §§232-237 (2d ed. 1956). Indeed the trustees' power of allocation does not seem even to be limited to accretions or receipts but would appear to extend in terms to any item of trust property. Furthermore, the trustees may make deductions from income for depreciation, amortization or waste in whatever amounts they see fit. They are, to be sure, required to exercise good faith in their dealings with the trust properties and furthermore they are admonished "to act in such manner as it is believed by them to be for the best interests of the Trust Fund, regarded as a whole." But they are immune from liability for errors of judgment however gross; their only stated liability is "for their own wilful acts or defaults."

In spite of the breadth of the language used, we do not conceive, however, that short of "wilful acts or defaults," the trustees are as free as the wind in their administration and management of the trusts. As stated by Judge Learned Hand in Stix v. Commissioner, 2 Cir., 1945, 152 F.2d 562, 563: ". . . no language, however strong, will entirely remove any power held in trust from the reach of a court of equity. After allowance has been made for every possible factor which could rationally enter into the trustee's decision, if it appears that he has utterly disregarded the interests of the beneficiary, the court will intervene. Indeed, were that not true, the power would not be held in trust at all; the language would be no more than a precatory admonition."

We may therefore assume that a Massachusetts court of equity at the behest of a beneficiary would intervene not only in the event of a wilful act or default by the trustees, but would also intervene in the event the trustees should act in utter

disregard of the rights of a beneficiary. Thus, no doubt, an appropriate court of the Commonwealth in the exercise of its equity jurisdiction would prevent the trustees from putting all, or nearly all, of the trust assets in wasting investments bearing a high rate of income for the benefit of a life tenant at the expense of a remainderman. And no doubt also, the court would step in to prevent the investment of all, or nearly all, the trust assets in a property yielding little or even no income for the benefit of a remainderman at the expense of a life beneficiary. But short of utter disregard of the rights of a life tenant or a remainderman springing from "arbitrary or dishonest conduct or bad faith, or fraud" Dumaine v. Dumaine, 1938, 301 Mass. 214, 224, 16 N.E.2d 625, 630, a Massachusetts court would have no external standard with which to measure the trustees' conduct. The area of the trustees' discretion, although not untrammelled, is about as broad as language can make it and the law permits, and within that area the trustees can act in the administration and management of their trusts to confer or withhold very substantial benefits as between the life tenants and remaindermen.

Perhaps no single power conferred by the decedent on the trustees would be enough to warrant inclusion of the corpora of the trusts in his estate. But we believe that the powers conferred on the trustees, considered as a whole, are so broad and all inclusive that within any limits a Massachusetts court of equity could rationally impose, the trustees, within the scope of their discretionary powers, could very substantially shift the economic benefits of the trusts between the life tenants and the remaindermen. We therefore conclude that under the trusts the decedent as long as he lived, in substance and effect and in a very real sense, in the language of [§2036(a)(2)], "retained for his life . . . the right . . . to designate the persons who shall possess or enjoy the property or the income therefrom; . . ." [2]

Since we believe that the corpora of the trusts is includible in the decedent's gross estate under [§2036] there is no need for us to consider the impact, if any, of [§2038].

A decree will be entered affirming the judgment of the District Court.

MAGRUDER, Chief Judge (dissenting). . . .

In Van Beuren v. McLoughlin, 1 Cir., 262 F.2d 315, decided by us December 12, 1958, we pointed out the drastic, perhaps even ruthless way in which [§2038] of the Internal Revenue Code operates against the taxpayer. The operation of [§2036(a)], upon which the opinion of the court is here based, is even more drastic, for whenever that section is properly applicable, there must be included in the gross estate the whole value of the corpus of any property which the decedent has transferred during his lifetime. On the other hand, under [§2038] there must be included in the gross estate only the value of the particular interests, the enjoyment of which had been subject to a change through the exercise of a described power vested in the decedent at the date of his death.

For the reasons explained in my dissenting opinion in Industrial Trust Co. v. Commissioner, 1 Cir., 1947, 165 F.2d 142, 148, 1 A.L.R.2d 144, I would think that the taxpayers here were entitled to claim that only [§2038] could apply and therefore in any event the whole of the value of the corpus ought not to have been included in the gross estate. But I go further, and suggest that neither [§2036(a)] nor [§2038] is properly applicable to this case.

At the outset, I would concede that the fact the grantor holds the described powers only as a fiduciary is not in itself enough to preclude the imposition of an estate tax. See Welch v. Terhune, 1 Cir., 1942, 126 F.2d 695, certiorari denied

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2 The language of the section makes it clear that it is immaterial that the decedent could exercise his power only in conjunction with his co-trustees.

1942, 317 U.S. 644. That case was a holding under [§2038], but I suppose that by a parity of reasoning the same result must be reached under [§2036(a)].

It is admitted by the court that the various types of broad powers of management conferred upon the trustees here are familiar grants to trustees as such, and that the case is a "very close" one. Confining itself narrowly to the facts of the particular case, the court says that perhaps "no single power conferred by the decedent on the trustees would be enough to warrant inclusion of the corpora of the trusts in his estate. But we believe that the powers conferred on the trustees, considered as a whole, are so broad and all inclusive that within any limits a Massachusetts court of equity could rationally impose, the trustees, within the scope of their discretionary powers, could very substantially shift the economic benefits of the trusts between the life tenants and the remaindermen." The court comes to this conclusion, though recognizing that "in the ordinary case" the power of a trustee in the exercise of familiar controls over investments, whereby he would be enabled (and perhaps required by his duties) to effect some shifting of benefits as between a life tenant and remaindermen, cannot amount to a "right" to designate the persons who shall enjoy the property or the income therefrom, within the meaning of [§2036(a)(2)].

It seems to me that, despite the undoubtedly broad powers of management vested in the trustees here, the court stretches the statutory language too far. It has to say that these powers of management, taken as a whole, because of their breadth make it impracticable for a Massachusetts court of equity effectively to control the exercise of these fiduciary powers, and therefore constitute a "right" (as distinguished from a "power" — the word used in [§2038]) to designate the persons who shall enjoy the property or the income therefrom. I know of no case that has gone this far.

Moreover, I cannot accept the premise that a Massachusetts court of equity would consider itself impotent to supervise the administration of these trusts so as to control any attempt to shift the incidence of their enjoyment.

It is difficult to imagine how the power "to exchange property for other property" could contribute to the defect the court found — ability to prefer the life tenants to the remaindermen or vice versa — except perhaps by a warped investment policy (and investment powers are specifically dealt with). A requirement that the trustee obtain fair value, even if not implied by the word "exchange," would certainly be imposed by any court of equity. And the Massachusetts court will look behind an apparently authorized exchange of property and strike it down if it conceals any skulduggery or if its result is detrimental in any way to the purposes of the trust the settlor created. See Morville v. Fowle, 1887, 144 Mass. 109, 112, 10 N.E. 766.

The investment powers, although obviously designed to permit a more imaginative program of investment than trustees usually may pursue, were not uncontrolled. Although the portfolio might contain, instead of "legals," investments in wasting assets companies and in stocks with attractive growth potential but paying no current dividends, the trustees were only authorized "to act in such manner as it is believed by them to be for the best interests of the Trust Fund regarded as a whole." I think this clearly requires the trustees to balance these extraordinary investments so that neither income nor principal would be prejudiced by the unusual nature of the portfolio. The Massachusetts court will enforce such a standard as "best interests" and will substitute its judgment for a bona fide, considered, but unsound decision of the trustee. Corkery v. Dorsey, 1916, 223 Mass. 97, 111 N.E. 795; see Hays' Estate v. Commissioner, 5 Cir., 1950, 181 F.2d 169, 171-172.

The accounting power given to the trustees is obviously corollary to this invest-

ment power and necessary to the successful maintenance of this balance; I believe it must be limited to this purpose and restricted to the best interests of the trust as a whole. It is somewhat ironic that a power apparently designed to relax the strict Massachusetts rules that capital gains and stock dividends are both always principal and cash dividends are income, so as to maintain the enjoyment of both the life beneficiaries and the remaindermen, is assigned as contributing to the "right" to prefer one over the other.

To me, all these powers are limited by standards which the Massachusetts court of equity could and would apply to supervise effectively the administration of the trust, and therefore none is either a [§2036(a)] "right" or a [§2038] "power." See Jennings v. Smith, 2 Cir., 1947, 161 F.2d 74. Nor, since in this context the whole cannot be greater than the sum of its parts, is anything gained by lumping them together.

NOTE

1. *Investment powers and §2036.* For cases in which broad investment powers were held to be outside §2036(a)(2) because subject to judicial scrutiny, see King's Estate v. Commissioner, 37 T.C. 973 (1962); United States v. Powell, 307 F.2d 821 (10th Cir. 1962).

In Estate of Downe v. Commissioner, 2 T.C. 967 (1943), the government sought to tax trust property under §2038 because the grantor retained "the option to direct in writing the Trustee to issue voting proxies on and to retain, sell, exchange, invest and reinvest any of the trust property held hereunder in such manner as he may direct and without liability to the Trustee for resulting loss." The court held that this option did not constitute a power to alter, amend, or revoke, citing cases holding that similar powers did not render the grantor liable for income tax on the trust income under §676 (taxing trust income to the grantor if he has a power to revest title to the corpus in himself, supra page 366). The court said: "The two sections have a cognate purpose." 2 T.C. at 973. But §676 is applicable only if title to the property can be "revested" in the grantor, and an investment clause can hardly be interpreted as a power to revest unless it permits the grantor to buy back the corpus for a nominal consideration or otherwise to benefit himself. Section 2038, however, speaks of a power to alter, amend, or revoke. Should investment powers that are beyond the reach of §676 necessarily escape §2038?

2. *References.* Kamanski and Spears, Recent Developments in the Taxation of Trusts, 1960 So. Calif. Tax Inst. 567, 582 et seq.; Pedrick, Grantor Powers and Estate Taxation: The Ties that Bind, 54 Nw. U.L. Rev. 527 (1959); Grey and Covey, State Street — A Case Study of Sections 2036(a) and 2038, 15 Tax L. Rev. 75 (1959). See also Committee on Estate and Tax Planning, A.B.A. Section of Real Estate Probate and Trust Law, Tax-Wise Drafting of Fiduciary Powers, 4 Tax Couns. Q. 333 and 489 (1960). Covey, Section 2036 — The New Problem Child of the Federal Estate Tax, 4 Tax Couns. Q. 121 (1960).

UNITED STATES v. ALLEN

293 F.2d 916 (10th Cir. 1961)

Before MURRAH, Chief Judge, and BRATTON and BREITENSTEIN, Circuit Judges.

MURRAH, Chief Judge.

This is an appeal from a judgment of the trial court awarding plaintiff-executors a refund for estate taxes previously paid.

The pertinent facts are that the decedent, Maria McKean Allen, created an irrevocable trust in which she reserved $\frac{3}{5}$ths of the income for life, the remainder to pass to her two children, who are the beneficiaries of the other $\frac{2}{5}$ths interest in the income. When she was approximately seventy-eight years old, the trustor-decedent was advised that her retention of the life estate would result in her attributable share of the corpus being included in her gross estate, for estate tax purposes. With her sanction, counsel began searching for a competent means of

divesture, and learned that decedent's son, Wharton Allen, would consider purchasing his mother's interest in the trust. At that time, the actuarial value of the retained life estate based upon decedent's life expectancy, was approximately $135,000 and her attributable share of the corpus, i.e., $\frac{3}{5}$ths, was valued at some $900,000. Upon consultation with his business advisers, Allen agreed to pay $140,000 for the interest, believing that decedent's actual life span would be sufficient to return a profit to him on the investment. For all intents and purposes, he was a bona fide third party purchaser — not being in a position to benefit by any reduction in his mother's estate taxes. The sale was consummated and, upon paying the purchase price, Allen began receiving the income from the trust.

At the time of the transfer, decedent enjoyed relatively good health and was expected to live her normal life span. A short time thereafter, however, it was discovered that she had an incurable disease, which soon resulted in her untimely death. As a result of the death, Allen ceased receiving any trust income and suffered a considerable loss on his investment.

The Internal Revenue Commissioner determined that $\frac{3}{5}$ths of the corpus, less the $140,000 purchase money, should be included in decedent's gross estate because (1) the transfer was invalid because made in contemplation of death, and (2) the sale was not for an adequate and full consideration.

Plaintiff-executors paid the taxes in accord with the Commissioner's valuation of the estate, and brought this action for refund, alleging that the sale of the life interest was for an adequate consideration; and that, therefore, no part of the trust corpus was properly includible in the gross estate.

The trial court held for plaintiffs, finding that the transfer was in contemplation of death, but regardless of that fact, the consideration paid for the life estate was adequate and full, thereby serving to divest decedent of any interest in the trust, with the result that no part of the corpus is subject to estate taxes.

Our narrow question is thus whether the corpus of a reserved life estate is removed, for federal estate tax purposes, from a decedent's gross estate by a transfer at the value of such reserved life estate. In other words, must the consideration be paid for the interest transferred, or for the interest which would otherwise be included in the gross estate?

In one sense, the answer comes quite simply — decedent owned no more than a life estate, could not transfer any part of the corpus, and Allen received no more than the interest transferred. And, a taxpayer is, of course, entitled to use all proper means to reduce his tax liability. See Cravens v. C.I.R., 10 Cir., 272 F.2d 895, 898. It would thus seem to follow that the consideration was adequate, for it was in fact more than the value of the life estate. And, as a practical matter, it would have been virtually impossible to sell the life estate for an amount equal to her share in the corpus. Cf. Sullivan's Estate v. C.I.R., 9 Cir., 175 F.2d 657.

It does not seem plausible, however, that Congress intended to allow such an easy avoidance of the taxable incidence befalling reserved life estates. This result would allow a taxpayer to reap the benefits of property for his lifetime and, in contemplation of death, sell only the interest entitling him to the income, thereby removing all of the property which he has enjoyed from his gross estate. Giving the statute a reasonable interpretation, we cannot believe this to be its intendment. It seems certain that in a situation like this, Congress meant the estate to include the corpus of the trust or, in its stead, an amount equal in value. I.e., see Helvering v. Hallock, 309 U.S. 106; C.I.R. v. Weymss, 324 U.S. 303; C.I.R. v. Estate of Church, 335 U.S. 632.[1]

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[1] In his treatise, Cutting the "Strings" on Inter Vivos Transfers in Contemplation of Death, 43 Minnesota Law Review 57, 70, 71, Professor Lowndes says:

The judgment of the trial court is therefore reversed and the case is remanded for further proceedings in conformity with the opinion filed herein.

BREITENSTEIN, Circuit Judge (concurring in result).

. . . .

Trustor-decedent in 1932 created an irrevocable trust and received no consideration therefor. She retained for life the right to income from $\frac{3}{5}$ths of the property which she placed in the trust. By the plain language of the statute that portion of the property held in the trust and devoted to the payment to her of income for life is includible within her gross estate. Such property is an "interest" of which she made a transfer with the retention of income for life.

The fact that the transfer of the life estate left her without any retained right to income from the trust property does not alter the result. As I read the statute the tax liability arises at the time of the inter vivos transfer under which there was a retention of the right to income for life. The disposition thereafter of that retained right does not eliminate the tax liability. The fact that full and adequate consideration was paid for the transfer of the retained life estate is immaterial. To remove the trust property from inclusion in decedent's estate there must be full and adequate consideration paid for the interest which would be taxed. That interest is not the right to income for life but the right to the property which was placed in the trust and from which the income is produced.

As the 1932 trust was irrevocable, trustor-decedent could thereafter make no unilateral transfer of the trust property. Granting that she could sell her life estate as that was a capital asset owned by her, such sale has no effect on the includibility in her gross estate of the interest which she transferred in 1932 with the retention of the right to income for life.

For the reasons stated I would reverse the judgment with directions to dismiss the case.

NOTE

1. *Relinquishment of life estate.* Would the concurring judge have reached the same result even if the decedent had lived for more than 3 years after the life estate was sold?

In computing the deficiency, why did the Internal Revenue Service reduce the amount includible in the decedent's gross estate by $140,000? See §2043 (a). Does the approach of the majority, or of the concurring judge, require this allowance?

In view of its purpose, was the transaction in the *Allen* case necessarily effected in contemplation of death? Supra page 1133.

See also Re Thurston's Estate, 36 Cal. 2d 207, 223 P.2d 12 (1950) (re California inheritance tax; accord, dictum).

2. *References.* Lowndes, Cutting the "Strings" on Inter Vivos Transfers in Contemplation of Death, 43 Minn. L. Rev. 57 (1958); Comment, Tax Consequences of a Gift in Contemplation of Death by a Joint Tenant or a Tenant by the Entirety, 61 Mich. L. Rev. 1335 (1963).

"(T)he adequacy of the consideration which will prevent a tax when an incident of ownership in connection with a taxable inter vivos transfer is relinquished in contemplation of death, will be measured against the value of the interest which would be taxable apart from the transfer in contemplation of death, rather than the property interest which is transferred. . . . (T)he determination of what interest is transferred in contemplation of death and what is adequate consideration to prevent a transfer in contemplation of death from being taxable, should be made on the basis of the tax effect of the transfer and the effect of the consideration on the transferor's taxable estate, rather than by the comparatively irrelevant rules of property law."

Section D. The Relationship Between §2036 and §2038

INDUSTRIAL TRUST CO. v. COMMISSIONER
165 F.2d 142 (1st Cir. 1947)

Before Magruder, Mahoney and Woodbury, Circuit Judges.

Mahoney, Circuit Judge.

The executor under the will of Milton J. Budlong, who died on July 5, 1941, has brought this petition for review of a decision of the Tax Court insofar as it determined a deficiency in the estate tax due.

On July 1, 1929, the decedent established four trusts, with himself as trustee, for the primary benefit of his three children, a daughter and two sons, and his sister, Mrs. George A. Woolsey, respectively. The issue of his three children were designated as remaindermen of all four trusts. A fifth trust created in the same indenture terminated prior to his decease by reason of the death of the beneficiary.

The indenture provided that the trustee should pay over to the several principal beneficiaries so long as they should respectively live, and, in the case of the decease of any of the principal beneficiaries who were children of the settlor, to their surviving children instead, such part or all of the net income of the trusts for their respective benefits as in each case the trustee in his discretion should from time to time deem advisable. It was provided, however, that with respect to Mrs. Woolsey such payment should aggregate $2,500 per annum during her life, with power in the trustee to expend such portions of the principal of her trust as might be necessary in addition to the net income thereof to produce the minimum annual payment. The trustee had discretion to add from time to time any undistributed income of any of the trusts to the principal of its respective trust. After the decedent should cease to act as trustee, the successor trustee was to pay over to Mrs. Woolsey $2,500 per annum from net income and from principal if necessary, accumulating the balance of the net income, if any. He was also to pay over to the settlor's daughter all of the net income of the trust for her benefit, not including, however, sums accumulated from prior years, and to pay over to each of the primary beneficiaries who was a son of the decedent who should have graduated from college, or should have attained the age of twenty-five years, all of the net income of the trust for his benefit, not including, however, income accumulated from prior years. The trust instrument further provided that "said trustee" should have power from time to time in his discretion to expend from the principal of said trusts such amounts as he might deem necessary for the benefit of the respective primary beneficiaries thereof or, in the case of the decease of such of them as were children of the settlor, their respective issue, in case of sickness or other emergency. There was no express reservation of power to alter, amend, revoke or terminate. The trusts were irrevocable and were not made in contemplation of death. Property was transferred to them prior to and subsequent to March 3, 1931.

The decedent on June 16, 1937 created an additional three trusts for the primary benefit of his daughter and two sons, respectively, with remainders to their respective issue. The decedent was trustee of each trust until his death. Each trust instrument provided that the trustee should pay over all the net income to the child named therein, provided that so long as the decedent should remain the sole trustee the trustee should pay over to the named child so much and no more of the net income as the trustee should in his absolute discretion

determine and should add any undistributed income to the capital of the trust estate. These trusts also were irrevocable and there was no express reservation of power to alter, amend, revoke or terminate. They were not made in contemplation of death.

The Commissioner concluded that the corpora of the trusts, except for the value of Mrs. Woolsey's life annuity, were includible in decedent's gross estate under [§§2036 and 2038] and determined a deficiency accordingly.

The Tax Court decided that as to the 1929 trusts the right to invade the corpus in case of sickness or other emergency, even if retained by the decedent, was not a power to "alter, amend, or revoke" within [§2038] and, therefore, no part of the property transferred to the trusts before March 3, 1931 was includible in the gross estate.* But the Tax Court held that the power reserved by the decedent, even though as trustee, to distribute the income or accumulate it in his discretion, amounted to a power to designate the persons who should possess or enjoy income within the meaning of [§2036], thus making all the property transferred to the 1929 trusts after March 3, 1931 and the entire corpora of the 1937 trusts includible in the gross estate. The property transferred before March 3, 1931 was not included since [the] joint resolution of that date has only prospective effect. Hassett v. Welch, 1938, 303 U.S. 303.† The present value of Mrs. Woolsey's life annuity of $2,500, insofar as it related to property transferred after March 3, 1931, was deducted, however, on the theory that as to this the decedent had no power to control.

The executor has petitioned for review on the ground that [§2036] does not apply to any of the trusts, and that even if it is applicable to the children's trusts it is not in the case of Mrs. Woolsey's trust. The Commissioner has not petitioned for review.

The two questions thus presented are (1) whether the corpora of trusts, the income of which could be paid to primary beneficiaries or withheld by the decedent-grantor and added to the corpus, eventually to go to the remaindermen, are includible in the decedent's gross estate under [§2036] on the ground that he possessed a right to designate the persons who should possess or enjoy the income, and (2) if so whether in the case of a trust with a primary beneficiary entitled to a minimum sum certain before the decedent could accumulate the income, the entire corpus of the trust, less the present value of the life annuity, is properly includible in the gross estate.

The taxpayer admits that the decedent had a power to determine who should receive the income as between the life tenants and the remaindermen. Nor does it contest the holding of the Tax Court that it is immaterial that the right to designate was exercisable by the decedent as "trustee." We think this clearly right in view of the reasoning of Welch v. Terhune, 1 Cir., 1942, 126 F.2d 695, certiorari denied, 1942, 317 U.S. 644, and similar cases, which although directly concerned with what is now [§2038] applies equally to [§2036].

The taxpayer contends, however, that a power to designate under [§2036] does not include a power limited only to choosing between two persons already named. An examination of the history of this phrase lends some credence to the contention. Under [§2038] the fact that the decedent can only choose among a limited class is immaterial. Commissioner of Internal Revenue v. Estate of Holmes [supra p. 1145]. . . . But under [§2038] only the interest that may be shifted is included in the gross estate. Commissioner v. Bridgeport City Trust Co., 2 Cir., 1941, 124 F.2d 48, certiorari denied, 1942, 316 U.S. 672. Thus is it

* See Jennings v. Smith, supra page 1155. — Ed.
† See also §2036(b). — Ed.

clear that a pre-1931 reserved power to designate who should enjoy the income was not sufficient to throw the entire corpus into the gross estate. . . . Since even an unlimited power to designate who should enjoy the income during the life of the decedent did not require the value of the corpus to be included in the gross estate under [§2038], nor under [§2036] prior to its amendment in 1931, the plaintiff urges that this was the power at which the legislation was aimed. The argument is bolstered by the fact that the Joint Resolution of March 3, 1931 was enacted to close the gap left by the decision in May v. Heiner, 1930, 281 U.S. 238, and the three subsequent cases, Burnet v. Northern Trust Co., 1931, 283 U.S. 782; Morsman v. Burnet, 1931, 283 U.S. 783; McCormick v. Burnet, 1931, 283 U.S. 784. The taxpayer urges that the Resolution should be interpreted in the light of that background, and that only a broad reserved power tantamount to a reserved life estate was intended to be included.

Although this argument is persuasive, we find no warrant in the plain words of the statute for making a distinction between narrow and broad powers. The decedent literally had a power to designate who should enjoy the income. A distinction such as suggested would introduce numerous complexities into the administration and interpretation of this section. The taxpayer would have us draw a line between a power to select among people named in the instrument and a power to select among people at large. But this would allow easy avoidance of the tax by careful draftsmanship without any change in substance. It would be a relatively simple matter to put in the instrument a list of persons which would cover practically anyone that the decedent might ever wish to designate. In interpreting an unambiguous statute we should not assume that Congress has acted so as to allow such easy avoidance of tax. Nor would any distinction based on the number of persons among whom the decedent might choose be sound as a matter of judicial interpretation. Thus, all the property transferred to the trust for the children after March 3, 1931, and the corpora of the 1937 trusts were rightly included in the gross estate.

To the extent to which the decedent retained a power to accumulate income in the trust for Mrs. Woolsey, his sister, it is the same as the other trusts. But it differs from the others, however, in that she was always to receive $2,500 per year out of income and principal, if necessary. The decedent could accumulate income only in excess of that amount. The Tax Court made what it considered the proper adjustment by discounting the value of the corpus of that trust by the value of the life annuity of Mrs. Woolsey. It was no doubt misled by the fact that the Commissioner, who had contended that all of the corpus of the trust for Mrs. Woolsey (including that part transferred before March 3, 1931, as well as after) should be included in the decedent's gross estate under [§2038], had excluded the value of the annuity. This may have been correct on the theory he was then pursuing that by the reservation of the power to invade in case of sickness or other emergency, the decedent had kept a string on the corpus in that he could give the corpus to her. But since she was entitled to a minimum of $2,500 per year which could come out of the corpus if necessary, this string was only over the difference between the entire corpus which he might conceivably give her and the annuity she was to receive in any event.

The Tax Court, however, held that [§2038] was not applicable but it nevertheless deducted the value of the annuity in applying [§2036]. We think the Tax Court erred by using an incorrect method of computing what proportion of the corpus should be included. The regulations provide that if the reservation of the right to designate pertains to a part only of the transferred property, or to a part only of income therefrom, only a corresponding proportion of the value of the transferred property is includible in the gross estate, Treas. Reg. §20.2036-1(a). Both

parties are essentially in agreement that the Tax Court's method was wrong, but there is however a dispute as to what is the proportion that should be included.

The taxpayer argues that a four percent rate should be postulated and, since the corpus ($34,668.40) at four percent would not yield $2,500, it maintains that no part of Mrs. Woolsey's trust should be included. We cannot agree that a four percent rate should always be assumed. The taxpayer relies on the regulations providing that in valuation of annuities, life estates, and remainders, a four percent rate is proper.* But it appears to us that the taxpayer has confused two different matters. Valuation of future interests is always a guess, though it should be an informed guess. Some rate must be assumed and the regulations generally postulate the four percent rate. But even in cases of valuation there are exceptions; and other rates will be used if some valid reason is shown for so doing, e.g., Hanley v. United States, 1945, 63 F. Supp. 73; Security-First National Bank v. Commissioner, 1937, 35 B.T.A. 815. Here the question is not one of determining the value of particular property; it is rather one of determining what portion of the property the decedent had in effect not completely relinquished because of his control of the income. There is no necessity for assuming an artificial rate when the actual income for past years can be ascertained. If for some reason the actual income over past years can not be determined, the Tax Court, whose function it is to find the facts, might be justified in assuming an average rate of four percent. But that is not our function as a reviewing court.

The Commissioner takes the position that the taxpayer has failed to show what part of the property should not be included because of the $2,500 annuity which the decedent could not control. He thus contends that there was a failure of proof and that the Tax Court was in error in failing to include all the property transferred after March 3, 1931, although he has not petitioned for review on this point. The Commissioner would thus have us affirm the decision of the Tax Court. We do not think that such action would be proper or in accord with the power given the circuit courts of appeal to remand for a rehearing if justice requires it. [§7482(c).] From the instrument, it is clear that the decedent could not control all the income, but only that in excess of $2,500. The part of the corpus transferred after March 3, 1931 necessary to produce the share of the $2,500 attributable to the post March 3, 1931 transfers should have been excluded. We see little difference between this type of reserved power and a power to designate half the income. There it seems clear that only one-half the corpus would be included. The same principle should have been applied here. We do not agree with the Commissioner's view that because the taxpayer failed to establish facts on which a fair apportionment can be made the Tax Court's determination at the erroneous figure should be sustained and this Court should not remand for further hearing. There is no support for the idea that the Commissioner's determination, which is clearly without rational foundation when applied where this portion of [§2036] is involved, should be enforced because the taxpayer has not shown the exact amount. . . .

The case is remanded to the Tax Court on this point for further proceedings.† That body may make findings as to whether the income realized ever exceeded $2,500 and thus determine whether in actuality the decedent retained any power. Even if the income did exceed $2,500 there should be excluded a proportionate part of the corpus necessary to produce an income of $2,500. . . .

MAGRUDER, Circuit Judge (dissenting in part).

* Regs. 105 §81.10(j). For decedents dying after December 31, 1951, the current Regulations provide that annuities, life estates, and remainders shall be valued on a $3\frac{1}{2}$ per cent basis. §20.2031-7. — ED.

† The proceedings on remand are not reported. — ED.

While the provisions of [§2036] and [§2038] overlap to some extent, it is important to stress that whenever [§2036] is applicable, the value of the corpus is included in the decedent's gross estate, whereas in the case of transfers falling within [§2038] there must be included only the value of the particular interests the enjoyment of which had been subject to a change through the exercise of a power in the decedent to alter, etc. Where the enjoyment of the primary life estate is subject to a power in the decedent to withhold the income and add it to principal, such power falls within the description of [§2038], and the value of the life estate must be included in decedent's gross estate. In the present case that would be true, it seems to me, as to all the transfers in trust, whether made before or after March 3, 1931.

But though the control which decedent had over the enjoyment of the life estates requires the value of those interests to be included in the gross estate, under [§2038], it does not follow that the same control requires the corpora of the trusts to be swept into the gross estate under [§2036]. The statutory language in [§2036], describing the power over income which has the tax consequence of requiring the corpus of the trust to be included as part of the decedent's gross estate, is markedly different from the language of [§2038].

As the opinion of the court points out, the amendment to [§2036] which Congress rushed through on March 3, 1931, was prompted by three decisions of the Supreme Court handed down March 2, 1931. Burnet v. Northern Trust Co., 283 U.S. 782; Morsman v. Burnet, 283 U.S. 783; McCormick v. Burnet, 283 U.S. 784. In the first two of these cases the grantor reserved to himself a life interest in the income (See Commissioner v. Northern Trust Co., 7 Cir., 41 F.2d 732 and Commissioner v. Morsman, 8 Cir., 44 F.2d 902); and the 1931 amendment to [§2036] covered these cases by providing that the value of the corpus should be included in the gross estate where the grantor had reserved to himself the possession or enjoyment of or the right to the income from the property transferred. In the *McCormick* case, supra, the trustees had been directed to accumulate the net income and add the same to the principal, subject, however, to the following provision:

> Said Trustee shall from time to time in each year pay out of said net income for charitable uses and purposes such sums and amount of money as said first party [the grantor] shall designate and request in writing, specifying to whom the same is to be paid and the particular charitable uses and purposes to which the same is to be applied.

The *McCormick* case obviously inspired the other phrase inserted by Congress in the 1931 amendment, "the right . . . to designate the persons who shall possess or enjoy . . . the income. . . ."

I agree with the court that the foregoing phrase cannot be limited to cases where the power to designate the persons who shall enjoy the income is unrestricted. Indeed, in the *McCormick* case, the power was not unrestricted, for there the income was to be accumulated by the trustees, subject only to a power in the decedent to direct that income to be paid to charities. The possible recipients of his bounty were thus limited to a class described in the trust instrument.

But it does not seem to me that a mere power to accumulate income aptly falls within the phrase "the right . . . to designate the persons who shall possess or enjoy . . . the income. . . ." I think it more likely that if Congress had intended that the reservation of this very familiar power should have the drastic consequence of requiring the inclusion in decedent's gross estate of the whole value of the corpus, it would have explicitly so provided. A power to withhold the income from the life tenant is not a power to designate who shall enjoy the

income. If the income is withheld from the life tenant and added to principal, no one will enjoy it as income. Nor does the power to accumulate income enable the holder of the power to designate who shall ultimately receive the same as augmented corpus. That is rigidly determined by the provisions of the trust instrument and is subject to contingencies which were beyond the control of the decedent. At any particular time when a decision is made not to pay income to the life tenant but to accumulate it, it could not be known who would ultimately benefit by such accumulation.

I therefore think that [§2038] applies here rather than [§2036].

NOTE

Note that nothing was included in respect of the property transferred by the grantor before 1931. The Treasury sought in the Tax Court to reach this property on the ground that the settlor's power to advance principal to the beneficiaries in case of sickness or other emergency was a power to "alter, amend, or revoke." This argument was rejected by the Tax Court. But the grantor also had the power to withhold income from three of the four principal beneficiaries. Was this a power to "alter, amend, or revoke"? The Tax Court did not deal specifically with this point; and since the government did not appeal, it could not have asked the Court of Appeals to reverse the Tax Court as to the pre-1931 transfers. Note Judge Magruder's dissenting opinion, and see the *Holmes' Estate* case, supra page 1145.

YAWKEY'S ESTATE v. COMMISSIONER

12 T.C. 1164 (1949)

[In 1935 the decedent and his wife created three trusts, one for each of their three granddaughters, naming themselves and their son-in-law as trustees. Each trust provided that until the beneficiary became 25, the trustees should pay for her benefit (or distribute to her, in their discretion) "such portion of the income as they deem for her best interest, retaining any balance not so used as an accumulation of income"; after the beneficiary reached the age of 25, the income was to be distributed to her quarterly. The trustees also had the power to transfer to the beneficiary, after she reached the age of 30, "such portions of the principal as in their judgment they deem for the best interest of the beneficiary." Upon the death of the income beneficiary, the corpus and any undistributed income of each trust was to go to her lineal descendants, with gifts over should there be no lineal descendants.]

OPPER, Judge: Whether any part of decedent's inter vivos transfers is to be included in the gross estate depends, as the case is presented and as we view the issues, on the answer to three questions. Respondent proposed the inclusion of the value at decedent's death of three trusts established by him for the benefit of his three granddaughters on two theories: First, that decedent, being a trustee, had a power alone or in conjunction with one of the two other trustees to alter, amend, or revoke the trusts, as envisaged by [§2038(a)(2)]; and, second, that in the same manner decedent had the right to designate the persons who should enjoy the income from the property within the meaning of [§2036(a)(2)]. Under the latter determination a smaller amount was proposed for inclusion, apparently because one of the three granddaughter beneficiaries had arrived at the age of 25 years when decedent died, and the trusts required the payment of all of the income to the respective beneficiaries upon their reaching that age.

Petitioner insists in the first place that decedent had no power or right in the premises because there was an adequate external standard by which the conduct of the trustees was to be measured and this so circumscribed their actions that

neither provision applies. This is the first question, and, if the contention prevailed, it would dispose of the entire controversy.

[The court held that the exercise by the trustees of their power was not governed by an enforceable external standard.]

For an additional reason, it is contended that [§2038] is inapplicable. This presents the second question. The clause upon which respondent relies for his conclusion that the enjoyment of the property was subject to alteration or termination through the exercise of a power by decedent is the provision permitting the trustees to transfer any part of the principal to a beneficiary after she becomes 30 years of age. At decedent's death all of the beneficiaries were under 30. The condition for the exercise of the power had accordingly not yet been fulfilled. Under authorities now too firmly established to question, a power based on such a future contingency does not suffice to bring the situation within [§2038]. Jennings v. Smith [supra p. 1155]; . . . And we find nothing in the language or result of the two cases recently decided by the Supreme Court to warrant a departure from the rule thus decisively settled. Commissioner v. Estate of Church, 335 U.S. 632; Estate of Spiegel v. Commissioner, 335 U.S. 701. The phraseology in these opinions most heavily relied upon by respondent[1] deals exclusively with title, possession, and enjoyment. This decedent could under no circumstances and in no contingency retain or recapture any of these attributes. The most that he could ever do and the most that respondent suggests that he could do was to change the title, possession, or enjoyment of the principal from the remaindermen to the life beneficiary. That would be an aspect of the transfers rendering them taxable, if the power existed currently, not under the survivorship theory of the *Hallock* case [309 U.S. 106], nor as intended to take effect at death, nor by retention of an interest in the income, cf. May v. Heiner, 281 U.S. 238, but under the express language of [§2038], which covers a power to alter or terminate. It thus resembles such cases as Jennings v. Smith, supra. But there is no assertion or implication of a reversionary interest in income or principal to assimilate the situation to that in the *Church* and *Spiegel* cases.

Most important, these cases dealt with [§2036], while the provision we are now considering is [§2038]. The difference in the statutory language seems to us, especially in the light of the decided cases, to carry decisive significance with respect to the time of the existence of decedent's retention. Section [2036] uses the language "for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death," whereas [§2038] employs the simple concept "at the date of his death." While it is true [§2038(b)] lists some legislative tests by which this approach may be considered as modified, it does not reach the present situation. Decedent's power

[1] ". . . In the *Church* case we stated that a trust transaction cannot be held to alienate all of a settlor's 'possession or enjoyment' under §811(c) [1939 Code] unless it effects 'a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter. In other words such a transfer must be immediate and out and out, and must be unaffected by whether the grantor lives or dies.' We add to that statement, if it can be conceived of as an addition, that it is immaterial whether such a present or future interest, absolute or contingent, remains in the grantor because he deliberately reserves it or because, without considering the consequences, he conveys away less than all of his property ownership and attributes, present or prospective. In either event the settlor has not parted with all of his presently existing or future contingent interests in the property transferred. He has therefore not made that 'complete' kind of trust transfer that §811(c) [1939 Code] commands as a prerequisite to a showing that he has certainly and irrevocably parted with his 'possession or enjoyment.' . . ." [Estate of Spiegel v. Commissioner, 335 U.S. 701.]

did not exist at his death under cases like Jennings v. Smith, supra . . . and its absence was not due to any such mere formality as the giving of notice or expiration of a formal waiting period. Cf. Estate of Paul Loughridge, 11 T.C. 968, 978. The inapplicability of the *Church* and *Spiegel* cases, dealing as they did with the entirely different language of [§2036], thus seems to us confirmed. Inclusion under [§2038] must accordingly be rejected.

The final proposition advanced by petitioner, presenting the third question, is that [§2036] is equally inapplicable both because decedent could not "designate" the persons who should enjoy the income, and, second, because he did not have "the right" to exercise it. The first statement is drawn from the provisions of the trust which, while permitting the trustees to withhold income from a life beneficiary under 25, require that it either be paid to her subsequently, or added to corpus. It is insisted that a complete designation of the ultimate taker is thus withheld from the trustees. The effect, however, of an addition to principal which was within the province of decedent and his cotrustees would be to shift the enjoyment from the life beneficiary to the ultimate taker of the principal, a remainderman whose identify might be indeterminate at the time but whose rights would thereby be tentatively fixed. Estate of Milton J. Budlong, supra. The "right" of decedent in the premises is questioned because decedent's two cotrustees could by their combined action frustrate any decision on his part under the majority rule established in the trust instrument. But if decedent joined with either of the other trustees, his action became effective. In our view that is what is meant by the statutory phrase "the right either alone or in conjunction with any person." Granted that decedent did not possess the right alone, it seems to us he clearly retained it in conjunction with the cotrustees. Estate of John Moir, 47 B.T.A. 765. We conclude that respondent's determination under [§2036], which, as we have said, affects only a portion of the transfers, was proper and must be sustained. . . .

NOTE

1. *Power to advance corpus to income beneficiary.* Although the power to accumulate the income of the third trust in *Yawkey's Estate* had expired because the beneficiary had reached the age of 25 before the decedent's death, the decedent had also reserved the power to advance corpus to the income beneficiary. If the power to withhold income is a power to "designate" who shall enjoy the income under §2036(a)(2), as the court holds, was the power to advance corpus also within §2036(a)(2) as a power to designate who shall enjoy the property? * (The power could not be exercised until the beneficiary reached the age of 30, an event that had not occurred when the decedent died, but the court holds that §2036, unlike §2038, does not require that the power be exercisable at the time of the decedent's death.) Assuming that the power to advance corpus was within §2036, would only the value of the entire trust be taxable, or would allowance have to be made for the value of the life interest? Note that under §2036 a power over the income alone brings the entire trust into the gross estate. Is there any reason why a power over the remainder alone should do less?

2. *Hager's Estate.* See again Commissioner v. Hager's Estate, supra page 1147. Note that the trusts were created in 1924. Would the case be decided in the same way today, now that the rule of May v. Heiner has been restored? If the grantor had retained the income for himself in 1924, when the trusts were created, they would not be reached by §2036(b). Should the lesser power to withhold or distribute the income result in a tax on the entire value of the trusts under §2038? Were the other powers retained by the

* Apparently the government did not make this argument: the deficiency notice claimed that the power to distribute or accumulate income was within the reach of both §2036 and §2038, but only §2038 was cited as authority for reaching the power to advance principal (12 T.C. at 1168-1169).

grantor sufficient by themselves to require the trusts to be included? See Covey, The Klauber Case and Sections 2036 (a)(1), 2037, and 2038 of the 1954 Code, 5 Tax Couns. Q. 129, 164 (1961):

> The decision [in *Hager's Estate*] was in error for in no event did decedent retain a power to affect the enjoyment of the original principal of the trust. This fact is reflected by the subsequent proceedings in the case itself. It was settled during the pendency of the estate's petition for certiorari on the basis of the value of the trust at decedent's death reduced by the original principal of the trust being included in decedent's gross estate.

3. *§2036 vs. §2038.* Would it matter whether the power to accumulate income of the two trusts that were included in the *Yawkey* case was taxed under §2036 or under §2038? If post-1931 transfers had been before the Supreme Court in Porter v. Commissioner, supra page 1144, Estate of Holmes v. Commissioner, supra page 1145, and Helvering v. City Bank Farmers Trust Co., supra page 1158, would §2036 have been applicable? What of the *Lober* case, supra page 1145? See Struthers v. Kelm, 218 F.2d 810 (8th Cir. 1955). Does §2036 reach all post-1931 transfers that can be reached by §2038? See Lewis, The Estate Tax (P.L.I. 1962) 63-66; Lewis, Transfers in Trust Under the New Estate Tax Law, 3 Amer. U. Tax Inst. 125, 130-131 (1951).

Section E. Transfers Taking Effect at Death: §2037

The scope of §2037. Section 2037, dealing with transfers taking effect at death, is a 1954 revision of a provision that came into the statute in 1949. From 1916 to 1949, transfers of the type now reached by §2037 were included in the gross estate only to the extent that they came within the postponed-possession-or-enjoyment clause as transfers "intended to take effect in possession or enjoyment at or after [the decedent's] death." See again page 1177 supra.

The scope of §2037 of present law can best be examined by assuming a transfer of this type: H transfers property in trust to pay the income to W, his wife, for her life; on W's death, the corpus is to be distributed to H if he is living; otherwise to S, H's son, or to S's estate. The requirement of §2037(a)(1) is satisfied, since S can obtain possession or enjoyment of the property only by surviving H, the transferor. Whether §2037(a)(2) is satisfied depends upon whether immediately before H's death the value of his reversionary interest exceeds 5 per cent of the value of the property. If H should die at 55 and if his wife is then 40, his reversionary interest would have been worth, immediately before his death, about 13 per cent of the value of the trust corpus. Put another way, the present worth of $1.00 due at the death of the younger of two persons, aged 55 and 40, provided the older survives, is about $0.13. If H dies at 55 when his wife is only 25, however, H's reversionary interest would have been worth, just before his death, slightly less than 5 per cent of the value of the corpus.* In the former case, since the decedent's reversionary interest was worth more than 5 per cent of the corpus, the trust would be includible under §2037. (The amount to be included would be the corpus less the value of the wife's life interest, since her interest was not dependent upon the husband's death.) In the latter case, however, since the reversionary interest was worth less than 5 per cent of the corpus, the trust would not be includible under §2037. Would the value of the husband's reversionary interest be includible under §2033?

The language of §2037 is relatively straightforward, presenting no more than

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* The student who wishes to see how these values are derived, or to work out the appropriate factor for other ages, will find the formula set out in Example 6, Actuarial Values for Estate and Gift Tax (I.R.S. Publication No. 11, 1959) 10.

its fair share of minor difficulties. But why *are* these the tests for including transfers taking effect at death? Are there any similar transfers that escape §2037? If so, why? If this provision is amended, what form might the changes take? A study of the evolution of §2037 from the primitive postponed-possession-or-enjoyment clause (§811(c), 1939 Code) will aid in answering these questions; otherwise, §2037 is like a military order sent by a distant headquarters to a unit that must act on it in ignorance of its setting or purpose. On the other hand, the taxation of transfers taking effect at death has had so tortuous a history that abbreviation is essential. What follows is only a summary. For a complete history of the period 1916-1945, see Eisenstein, Estate Taxes and the Higher Learning of the Supreme Court, 3 Tax L. Rev. 395, 421-502 (1948); for later developments, see Bittker, The Church and Spiegel Cases: Section 811(c) Gets a New Lease on Life, 58 Yale L.J. 825 (1949), and Church and Spiegel: The Legislative Sequel, 59 id. 395 (1950).

The decedent's life as a measuring stick. By accident or otherwise, the first three cases in this area to reach the Supreme Court arrived in inverse order to the strength of the government's position. In Shukert v. Allen, 273 U.S. 545 (1927), the government maintained that a transfer in trust to accumulate the income for 30 years, with distribution of the corpus and accumulated income to be made to the settlor's children or their issue at that time, was includible in the transferor's estate. The settlor died shortly after creating the trust. Because the term of the trust was greater than the settlor's life expectancy (about 16 years) when the transfer was made, the government asserted that the transfer was "intended to take effect in possession or enjoyment at or after his death." The Supreme Court held to the contrary, but the ground of its decision was not altogether clear:

> The transfer was immediate and out and out, leaving no interest remaining in the testator. The trust in its terms has no reference to his death but is the same and unaffected whether he lives or dies. Although the Circuit Court of Appeals seems to have thought otherwise, the interest of the children respectively was vested as soon as the instrument was executed, even though it might have been divested as to any one of them in favor of this issue if any, or of the surviving beneficiaries, if he died before the termination of the trust. See Gray, The Rule Against Perpetuities, §108(3). It seems plain from the little evidence that was put in that the testator was not acting in contemplation of death as a motive for his act, or otherwise, except in the sense that he was creating a fund intended to secure his children from want in their old age, whoever might dissipate the considerable property that he retained and left at his death; and that being fifty-six years old, if he thought about it, he would have contemplated the possibility or probability of his being dead before the emergency might arise. Of course it was not argued that every vested interest that manifestly would take effect in actual enjoyment after the grantor's death was within the statute. There certainly is no transfer taking effect after his death to be taxed under [the clause relating to transfers intended to take effect in possession or enjoyment at or after death].
>
> It is not necessary to consider whether the petitioner goes too far in contending that this clause should be construed to refer only to transfers of property the possession or enjoyment of which does not pass from the grantor until his death. But it seems to us tolerably plain, that when the grantor parts with all his interest in the property to other persons in trust, with no thought of avoiding taxes, the fact that the income vested in the beneficiaries was to be accumulated for them instead of being handed to them to spend, does not make the trust one intended to take effect in possession or enjoyment at or after the grantor's death. [273 U.S. at pp. 547-548.]

Believing that it might have lost Shukert v. Allen because the term of the trust (30 years) was not expressly linked to the settlor's death, the government soon sought review of another decision involving five trusts whose terms were depend-

ent on the settlor's death. Reinecke v. Northern Trust Co., 278 U.S. 339 (1929). The decedent had created five trusts,* four of which were to end five years after his death or upon the death of the life tenants, whichever occurred first. The fifth trust was to terminate five years after his death or upon the death of the life tenant, whichever occurred later. The Court held that these five trusts were not reached by the postponed-possession-or-enjoyment clause:

But the question much pressed upon us remains, whether, the donor having parted both with the possession and his entire beneficial interest in the property when the trust was created, the mere passing of possession or enjoyment of the trust fund from the life tenants to the remaindermen after the testator's death, as directed, and after the enactment of the statute, is included within its taxing provisions. That question, not necessarily involved, was left unanswered in Shukert v. Allen, 273 U.S. 545. There the gift of a remainder interest, having been made without reference to the donor's death, although it did in fact vest in possession and enjoyment after his death, was held not to be a transfer intended to take effect in possession or enjoyment at or after the donor's death, and for that reason not to be subject to the tax. But here the gift was intended to so take effect, although the transfer which effected it preceded the death of the settlor and was itself not subject to the tax unless made so by the circumstances that the possession or enjoyment passed as indicated.

In its plan and scope the tax is one imposed on transfers at death or made in contemplation of death and is measured by the value at death of the interest which is transferred. . . . It is not a gift tax, and the tax on gifts once imposed by the Revenue Act of 1924 has been repealed, 44 Stat. 126. One may freely give his property to another by absolute gift without subjecting himself or his estate to a tax, but we are asked to say that this statute means that he may not make a gift inter vivos, equally absolute and complete, without subjecting it to a tax if the gift takes the form of a life estate in one with remainder over to another at or after the donor's death. It would require plain and compelling language to justify so incongruous a result and we think it is wanting in the present statute.

It is of significance, although not conclusive, that . . . the tax [is imposed] on the net estate of decedents, and that the miscellaneous items of property required . . . to be brought into the gross estate for the purpose of computing the tax, unless the present remainders be an exception, are either property transferred in contemplation of death or property passing out of the control, possession or enjoyment of the decedent at his death. They are property held by the decedent in joint tenancy or by the entirety, property of another subject to the decedent's power of appointment, and insurance policies effected by the decedent on his own life, payable to his estate or to others at his death. The two sections, read together, indicate no purpose to tax completed gifts made by the donor in his lifetime not in contemplation of death, where he had retained no such control, possession or enjoyment. In the light of the general purpose of the statute and the language of [§2033] explicitly imposing the tax on net estates of decedents, we think it at least doubtful whether the trusts or interests in a trust intended to be reached by the phrase in [§811(e), 1939 Code] "to take effect in possession or enjoyment at or after his death," include any others than those passing from the possession, enjoyment or control of the donor at his death and so taxable as transfers at death under [§2033]. That doubt must be resolved in favor of the taxpayer. . . . Doubts of the constitutionality of the statute, if construed as contended by the government, would require us to adopt the construction, at least reasonably possible here, which would uphold the act. [278 U.S. at 347-349.]

After Reinecke v. Northern Trust Co. was decided, the government gave up the effort to tax transfers merely because they were contingent on the transferor's death — where his life was only a measuring stick, as it were. Nor did the

* Two other trusts involved in the same case were revocable, and were held to be includible in the gross estate. The five trusts described in the text were revocable with the consent of the beneficiaries, but this power was held irrelevant under the statute then in effect. Supra page 1159, note.

Treasury ask Congress to change the law, possibly because of the constitutional doubts voiced in the last sentence quoted above. Not until 1949, as will be seen, was this type of transfer again threatened by the estate tax.

In the meantime, the government sought to make the most of the statements in Shukert v. Allen and Reinecke v. Northern Trust Co. that the proper province of the postponed-possession-or-enjoyment clause was the transfer under which possession or enjoyment passes "from" the transferor at his death. One branch of the Treasury's attack was on transfers with reservation of income; this attack was routed in 1931 by May v. Heiner, as is described supra page 1178, and Congress had to come to the aid of the Treasury by enacting what is now §2036. The other type of transfer which the Treasury sought to tax after Reinecke v. Northern Trust Co. was the trust with a reversionary interest retained by the transferor, the type described at the beginning of this section. If such a transfer was not reached by the postponed-possession-or-enjoyment clause, the Treasury might have reasoned, what *was* that clause's function?

The early "reversionary interest" cases. In seeking to apply the statutory phrase to transfers with reversionary interests, the Treasury seemed at long last to be on the right track. In Klein v. United States, 283 U.S. 231 (1931), the Supreme Court unanimously held for the government with respect to such a transfer. The grantor had created a trust to pay the income to his wife for her life. At her death, the property was to revert to the grantor if living; but if he predeceased her, she was to get the property in fee simple. He died before his wife, and the court held that the property was includible in his estate:

> Nothing is to be gained by multiplying words in respect of the various niceties of the art of conveyancing or the law of contingent and vested remainders. It is perfectly plain that the death of the grantor was the indispensable and intended event which brought the larger estate [i.e., fee simple ownership rather than a life estate] into being for the grantee and effected its transmission from the dead to the living, thus satisfying the terms of the taxing act and justifying the tax imposed. [283 U.S. at 234.]

But only four years later, the "niceties of the art of conveyancing" turned out to be more durable, and profitable, than was thought. The Supreme Court was asked to review two cases, each involving a trust to pay the income to a child of the grantor for the child's life. In one, Helvering v. St. Louis Union Trust Co., 296 U.S. 39 (1935), there were gifts over on the child's death, but if the child predeceased the settlor, the trust was to terminate and the property was to revert to the settlor. The settlor predeceased the life tenant. The Supreme Court, by a 5-to-4 vote, held that the property was not includible:

> The grantor here, by the trust instrument, left in himself no power to resume ownership, possession, or enjoyment, except upon a contingency in the nature of a condition subsequent, the occurrence of which was entirely fortuitous so far as any control, design, or volition on his part was concerned. After the execution of the trust he held no right in the trust estate which in any sense was the subject of testamentary disposition. His death simply put an end to what, at best, was a mere possibility of a reverter by extinguishing it; that is to say, by converting what was merely possible into an utter impossibility. [296 U.S. at 43.]*

The *Klein* case was distinguished on the ground that:

> only a life estate was vested, the remainder being retained by the grantor; and whether that should ever become vested in the grantee depended upon the condition precedent that the grantor die during the life of the grantee. The grantor having died first, his death clearly effected a transmission of the larger estate to the grantee. But here the

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* The other case, Becker v. St. Louis Union Trust Co., 296 U.S. 48 (1935), involved a similar trust and was decided in the same way. — ED.

grantor parted with the title and all beneficial interest in the property, retaining no right with respect to it which would pass to any one as a result of his death. Unlike the *Klein* case, where the death was the generating source of the title, here, as the court below said, the trust instrument and not the death was the generating source. The death did not transmit the possibility, but destroyed it. [296 U.S. at 45-46.]

Helvering v. Hallock: the end of verbal niceties? There was, clearly enough, only a verbal distinction between taxable *Klein* reversionary interests (retained by the grantor subject to divestment if he predeceased the beneficiary) and non-taxable *St. Louis Union Trust Co.* reversionary interests (contingent on the beneficiary's predeceasing the settlor). The distinction was administratively unworkable, and within five years the problem was back in the Supreme Court when certiorari was granted in three cases involving reversionary interests created by diverse legal formulas. Under the style of Helvering v. Hallock, 309 U.S. 106 (1940), the Supreme Court decided all three cases for the government:

The terms of these grants [in the cases before the Court] differ in detail from one another, as all three differ from the formulas of conveyance used in the *Klein* and *St. Louis Trust* cases. It therefore becomes important to inquire whether the technical forms in which interests contingent upon death are cast should control our decision. If so, it becomes necessary to determine whether the differing terms of conveyance now in issue approximate more closely those used in the *Klein* case and are therefore governed by it, or have a greater verbal resemblance to those that saved the tax in the *St. Louis Trust* cases. Such an essay in linguistic refinement would still further embarrass existing intricacies. It might demonstrate verbal ingenuity, but it could hardly strengthen the rational foundations of law. The law of contingent and vested remainders is full of casuistries. There are great diversities among the several states as to the conveyancing significance of like grants; sometimes in the same state there are conflicting lines of decision, one series ignoring the other. Attempts by the Board of Tax Appeals and the Circuit Courts of Appeals to administer [§811(c), 1939 Code, the postponed-possession-or-enjoyment clause] by reference to these distinctions abundantly illustrate the inevitable confusion. One of the cases at bar, No. 399, reveals vividly the snares which inevitably await an attempt to base estate tax law on the "niceties of the art of conveyancing." In connection with the ascertainment of its own death duties, the Supreme Court of Errors of Connecticut defined the nature of the interest which the decedent in that case retained after his inter vivos transfer. Bryant v. Hackett, 118 Conn. 233; 171 A. 664. And yet the nature of that interest under Connecticut law and the scope of the Connecticut court's adjudication of that interest were made the subject of lively controversy before us. The importation of these distinctions and controversies from the law of property into the administration of the estate tax precludes a fair workable tax system. Essentially the same interests, judged from the point of view of wealth, will be taxable or not, depending upon elusive and subtle casuistries which may have their historic justification but possess no relevance for tax purposes. These unwitty diversities of the law of property derive from medieval concepts as to the necessity of a continuous seisin. Distinctions which originated under a feudal economy when land dominated social relations are peculiarly irrelevant in the application of tax measures now so largely directed toward intangible wealth.

Our real problem, therefore, is to determine whether we are to adhere to a harmonizing principle in the construction of [§811(c), 1939 Code] or whether we are to multiply gossamer distinctions between the present cases and the three earlier ones. Freed from the distinctions introduced by the *St. Louis Trust* cases, the *Klein* case furnishes such a harmonizing principle. Does, then, the doctrine of *stare decisis* compel us to accept the distinctions made in the *St. Louis Trust* cases as starting point for still finer distinctions spun out of the tenuousities of surviving feudal law? We think not. We think the *Klein* case rejected the presupposition of such distinctions for the fiscal judgments which [§811(c), 1939 Code] demands.

We recognize that stare decisis embodies an important social policy. It represents an element of continuity in law, and is rooted in the psychologic need to satisfy reasonable expectations. But stare decisis is a principle of policy and not a mechanical formula of

adherence to the latest decision, however recent and questionable, when such adherence involves collision with a prior doctrine more embracing in its scope, intrinsically sounder, and verified by experience.

Nor have we in the *St. Louis Trust* cases rules of decision around which, by the accretion of time and the response of affairs, substantial interests have established themselves. No such conjunction of circumstances requires perpetuation of what we must regard as the deviations of the *St. Louis Trust* decisions from the *Klein* doctrine. We have not before us interests created or maintained in reliance on those cases. We do not mean to imply that the inevitably empiric process of construing tax legislation should give rise to an estoppel against the responsible exercise of the judicial process. But it is a fact that in all the cases before us the settlements were made and the settlors died before the *St. Louis Trust* decisions.*

Nor does want of specific Congressional repudiation of the *St. Louis Trust* cases serve as an implied instruction by Congress to us not to reconsider, in the light of new experience, whether those decisions, in conjunction with the *Klein* case, make for dissonance of doctrine. It would require very persuasive circumstances enveloping Congressional silence to debar this Court from re-examining its own doctrines. To explain the cause of non-action by Congress when Congress itself sheds no light is to venture into speculative unrealities. Congress may not have had its attention directed to an undesirable decision; and there is no indication that as to the *St. Louis Trust* cases it had, even by any bill that found its way into a committee pigeon-hole. Congress may not have had its attention so directed for any number of reasons that may have moved the Treasury to stay its hand. But certainly such inaction by the Treasury can hardly operate as a controlling administrative practice, through acquiescence, tantamount to an estoppel barring reëxamination by this Court of distinctions which it had drawn. Various considerations of parliamentary tactics and strategy might be suggested as reasons for the inaction of the Treasury and of Congress, but they would only be sufficient to indicate that we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle.

This Court, unlike the House of Lords, has from the beginning rejected a doctrine of disability at self-correction. Whatever else may be said about want of Congressional action to modify by legislation the result in the *St. Louis Trust* cases, it will hardly be urged that the reason was Congressional approval of those distinctions between the *St. Louis Trust* and the *Klein* cases to which four members of this Court could not give assent. By imputing to Congress a hypothetical recognition of coherence between the *Klein* and the *St. Louis Trust* cases, we cannot evade our own responsibility for reconsidering, in the light of further experience, the validity of distinctions which this Court has itself created. Our problem then is not that of rejecting a settled statutory construction. The real problem is whether a principle shall prevail over its later misapplications. Surely we are not bound by reason or by the considerations that underlie stare decisis to persevere in distinctions taken in the application of a statute which, on further examination, appear consonant neither with the purposes of the statute nor with this Court's own conception of it. We therefore reject as untenable the diversities taken in the *St. Louis Trust* cases in applying the *Klein* doctrine — untenable because they drastically eat into the principle which those cases professed to accept and to which we adhere. [309 U.S. at 116-122.]

Chief Justice Stone concurred in the result on the ground that the *Klein* case was controlling in all instances before the Court. Justices Roberts and McReynolds dissented, asserting that there was a difference "of substance, not merely of

* The Treasury Department subsequently provided by regulation that property transferred between November 11, 1935 (the date of the decisions in the *St. Louis Union Trust Co.* cases), and January 29, 1940 (the date of the *Hallock* decision), would not be taxed if (a) the Commissioner determines that the transfer was made in the image of the *St. Louis Union Trust Co.* limitations rather than on the *Klein* model, and (b) the transfer was reported as a completed gift without allowance for the donor's reversionary interest. The Commissioner's determination is final. Regs. §20.2037-1(h). See Internal Revenue Code §7805(b) and Helvering v. Griffiths, 318 U.S. 371, 397-399 (1943). — Ed.

terminology" between the *Klein* and *St. Louis Union Trust Co.* trusts, but that even if there were not, the *St. Louis Union Trust Co.* cases should be preserved out of respect for the doctrine of stare decisis and because Congress had re-enacted the statute without change after these cases were decided.

Questions after Hallock. The *Hallock* case at first seemed to be the final step of a long journey; now we know that it was only the end of the beginning. Two questions that particularly called for decision were these:

1. Did the statute reach a reversionary interest that was not expressly reserved by the grantor but instead arose by operation of law? In the cases passed on by the Supreme Court, the reversionary interest had been created by the express language of the trust indenture. But what if H transfers property in trust to pay the income to W for H's life, remainder to H's children living at the time of his death, with no gift over if the children all predecease H? In these circumstances H would have a reversionary interest by operation of law. It was argued that such a trust was not reached by the statute, however, at least not without proof that the transfer was "intended" to take effect in possession or enjoyment at or after death. It was of course possible H had no intention of reserving anything, and that his reversionary interest existed only because the draftsman failed to provide for a final gift over. But even an *express* reservation of a reversionary interest might result from a draftsman's caution and not from the settlor's deliberation, and the *Hallock* case did not make any inquiry into the question of whether the reversionary interests there involved were *deliberately* retained.

2. Was the "remoteness" of the reversionary interest relevant?* The principal Supreme Court cases had all concerned settlors who would recapture transferred property if they outlived a wife or a child. The possibility of survivorship was sufficiently substantial so that the settlor might have retained the reversionary interest deliberately, and perhaps a conclusive presumption that the transfer was "intended" to take effect in possession or enjoyment at or after his death was warranted. But what if a settlor transfers property in trust for his wife for his life, remainder to her if she survives him, otherwise to those of his children and their issue who survive him, with a reversionary interest in the settlor's estate if his wife, his children, and the issue of his children all predecease him? See Estate of Goodyear v. Commissioner, 2 T.C. 885 (1943), where a trust fund of about $350,000 would have reverted to the decedent only if she had survived a son, four grandchildren, and their issue, eight great-grandchildren being alive at the time of her death; the value of the reversionary interest was $0.0000000000876. If the settlor's reversionary interest was virtually worthless, because conditioned on a remote possibility, was the transfer "intended to take effect in possession or enjoyment at or after his death," as that clause was interpreted in the *Hallock* case?

The answers to Hallock's questions: Church and Spiegel. In October, 1947, Spiegel's Estate v. Commissioner, 335 U.S. 701 (1949), and Commissioner v. Church, 335 U.S. 632 (1949), which raised both of these questions, were argued in the Supreme Court. In both cases, the government asserted that the grantor of a trust possessed a remote reversionary interest arising by operation of law, because the instrument of transfer did not provide for all contingencies. In the *Spiegel* case, the corpus was worth about $1.1 million when the decedent died, and its inclusion in the estate produced an estate tax of about $450,000; the grantor's reversionary interest (dependent on outliving his children and their issue) was

* In 1945, the Supreme Court said in several cases that the remoteness of the decedent's reversionary interest was irrelevant. But there were certain special circumstances in these cases that led some observers to think that the issue was not yet foreclosed. See Bittker, The Church and Spiegel Cases: Section 811(c) Gets a New Lease on Life, 58 Yale L.J. 825, 836 n.65 (1949).

worth $4500 when the trust was created and about $85 just before he died.* On the last day of the 1947 term, the Supreme Court ordered reargument (68 Sup. Ct. 1522, 1524), requesting counsel to discuss nine questions which in effect inquired whether the Court had been mistaken in its view of the postponed-possession-or-enjoyment clause in every important case before Helvering v. Hallock. The cases were reargued in accordance with these orders in October, 1948, and were decided in January, 1949. In deciding the *Church* case, in which the decedent had not only a reversionary interest but also a pre-1931 life estate, the Court (three justices dissenting) did not confine itself to the reversionary interest issue, but decided the case by overruling May v. Heiner, as stated supra page 1181. Referring to the fact that Church had retained a life estate in the transferred property, the Court said:

> How is it possible to call this trust transfer "complete" except by invoking a fiction? Church was sole owner of the stocks before the transfer. Probably their greatest property value to Church was his continuing right to get their income. After legal title to the stocks was transferred, somebody still owned a property right in the stock income. That property right did not pass to the trust beneficiaries when the trust was executed; it remained in Church until he died. He made no "complete" gift effective before that date, unless we view the trust transfer as a "complete" gift to the trustees. But Church gave the trustees nothing, either partially or completely. He transferred no right to them to get and spend the stock income. And under the teaching of the *Hallock* case, quite in contrast to that of May v. Heiner, passage of the mere technical legal title to a trustee is not necessarily crucial in determining whether and when a gift becomes "complete" for estate tax purposes. Looking to substance and not merely to form, as we must unless we depart from the teaching of *Hallock,* the inescapable fact is that Church retained for himself until death a most valuable property right in these stocks — the right to get and to spend their income. Thus Church did far more than attach a "string" to a remotely possible reversionary interest in the property, a sufficient reservation under the *Hallock* rule to make the value of the corpus subject to an estate tax. Church did not even risk attaching an unbreakable cable to the most valuable property attribute of the stocks, their income. He simply retained this valuable property, the right to the income, for himself until death, when, for the first time the stock with all its property attributes "passed" from Church to the trust beneficiaries. Even if the interest of Church was merely "obliterated," in May v. Heiner language, it is beyond all doubt that simultaneously with his death, Church no longer owned the right to the income; the beneficiaries did. It had then "passed." It never had before. For the first time, the gift had become "complete."
>
> Thus, what we said in *Hallock* was not only a repudiation of the reasoning which was advanced to support the two cases (*St. Louis Trust and Becker*) that *Hallock* overruled, but also a complete rejection of the rationale of May v. Heiner on which the two former cases had relied. *Hallock* thereby returned to the interpretation of the "possession or enjoyment" section under which an estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter. In other words such a transfer must be immediate and out and out, and must be unaffected by whether the grantor lives or dies. See Shukert v. Allen, 273 U.S. 545, 547; Smith v. Shaughnessy, 318 U.S. 176. [335 U.S. at 644-646.]

Unlike Church, Spiegel had not retained a life interest. In deciding the *Spiegel* case, therefore, the Court had to decide the effect of a remote reversionary interest arising by operation of law. It held that reversionary interests arising by

* The existence of a reversionary interest was disputed in both cases; the Supreme Court accepted a lower court determination that there was one in the *Spiegel* case, and did not reach this issue in the *Church* case.

operation of law were as fatal as those that were expressly reserved, and that the remoteness of the decedent's interest was irrelevant:

First. In Commissioner v. Church, we have discussed the *Hallock* holding in relation to the scope of the "possession or enjoyment" provision of §811(c) [1939 Code] and need not elaborate what we said there. What we said demonstrates that the taxability of a trust corpus under this provision of §811(c) does not hinge on a settlor's motives, but depends on the nature and operative effect of the trust transfer. In the *Church* case we stated that a trust transaction cannot be held to alienate all of a settlor's "possession or enjoyment" under §811(c) unless it effects "a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property. After such a transfer has been made, the settlor must be left with no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter. In other words such a transfer must be immediate and out and out, and must be unaffected by whether the grantor lives or dies." We add to that statement, if it can be conceived of as an addition, that it is immaterial whether such a present or future interest, absolute or contingent, remains in the grantor because he deliberately reserves it or because, without considering the consequences, he conveys away less than all of his property ownership and attributes, present or prospective. In either event the settlor has not parted with all of his presently existing or future contingent interests in the property transferred. He has therefore not made that "complete" kind of trust transfer that §811(c) commands as a prerequisite to a showing that he has certainly and irrevocably parted with his "possession or enjoyment." Any requirement less than that which we have outlined, such as a postdeath attempt to probe the settlor's thoughts in regard to the transfer, would partially impair the effectiveness of the "possession or enjoyment" provision as an instrument to frustrate estate tax evasions. To this extent it would defeat the precise purpose for which the provision was originated and which prompted Congress to include it in §811(c). . . .

Second. It is contended that since the monetary value of the settlor's contingent reversionary interest is small in comparison with the total value of the corpus, the possession or enjoyment provision of §811(c) should not be applied. But inclusion of a trust corpus under that provision is not dependent upon the value of the reversionary interest. . . . The question is not how much is the value of a reservation, but whether after a trust transfer, considered by Congress to be a potentially dangerous tax evasion transaction, some present or contingent right or interest in the property still remains in the settlor so that full and complete title, possession or enjoyment does not absolutely pass to the beneficiaries until at or after the settlor's death. [335 U.S. at 705-707.]

There were forceful dissents in both cases. See Bittker, The *Church* and *Spiegel* Cases: Section 811(c) Gets a New Lease on Life, 58 Yale L.J. 825 (1949).

The legislative sequel to Church and Spiegel: Technical Changes Act of 1949. As soon as the *Church* and *Spiegel* cases were decided, speculation commenced on whether Reinecke v. Northern Trust Co. had been overruled sub silentio.* When the Supreme Court said that to avoid the postponed-possession-or-enjoyment clause, a transfer "must be unaffected by whether the grantor lives or dies," did it mean that a transfer was taxable if (as in the *Northern Trust Co.* case) the grantor's life was used as a yardstick to measure the term of a trust, even though the grantor reserved no interest for himself? Even if the Supreme Court did not intend to take this step, was there any reason to tax the trust in the *Spiegel* case, which was to terminate on the grantor's death, because he would recapture the corpus in the highly unlikely event that he outlived his children and their issue, but exclude a trust that was identical in all respects except that the virtually worthless reversionary interest was vested in someone else? The im-

* It had been previously argued, without success, that the *Northern Trust Co.* case had been overruled by implication by *Hallock.* Commissioner v. Lasker's Estate, 141 F.2d 889 (7th Cir. 1944).

pact of the *Spiegel* case on Reinecke v. Northern Trust Co. was not settled by the judiciary, however, because Congress intervened by enacting the Technical Changes Act of 1949. It has already been pointed out, supra page 1181, that this statute commenced the task of obliterating the *Church* case. It was more generous to the *Spiegel* case. For transfers after October 7, 1949, it provided that the transferred property would be included if the transferee was required to survive the transferor to obtain possession or enjoyment of the property. Thus Reinecke v. Northern Trust Co. was overruled prospectively.* A transfer to trustees to accumulate the income during the settlor's life, with distribution to the son or the son's estate to be made on the settlor's death, was taxable under this part of the 1949 Act, even though the decedent retained no interest of any type. In the case of transfers made on or before October 7, 1949, however, the 1949 Act rejected the sweeping position of the *Spiegel* case. Such transfers were not to be included in the gross estate unless the reversionary interest (a) arose by the express terms of the instrument of transfer and not by operation of law, and (b) had a value immediately before the decedent's death of more than 5 per cent of the value of the transferred property. The 1949 legislation is discussed in detail in Bittker, Church and Spiegel: The Legislative Sequel, 59 Yale L.J. 395 (1950); Pavenstedt, Congress Deactivates Another Bombshell: The Mitigation of Church and Spiegel, 5 Tax L. Rev. 309 (1950).

The 1954 legislation: restoration of Reinecke v. Northern Trust Co. In 1954, Congress intervened once more. Section 2037 of the 1954 Code retained the 1949 rules for transfers on or before October 7, 1949, but revised the treatment of transfers made after October 7, 1949. The rule of Reinecke v. Northern Trust Co. was restored, so that the use of the settlor's life as a measuring stick is not fatal unless a reversionary interest was retained, and the 5 per cent rule was extended to post-1949 transfers, but it is applicable to interest arising by operation of law as well as to those created by the express language of the instrument of transfer. In recommending this change, the Senate Finance Committee said:

Where the decedent has disposed of all, or substantially all, of his rights to property long before his death, it appears unduly harsh to subject the property to estate tax merely because the ultimate taker of the property is determined at the time of the decedent's death. (S. Rept., p. 123.) Is §2037(a), as amended in 1954, a sound solution to this problem? Was the 1949 legislation better? Would it be sounder policy instead to tax only the actuarial value, just before death, of the reversionary interest?

COMMISSIONER v. MARSHALL'S ESTATE

203 F.2d 534 (3d Cir. 1953)

Before MARIS, KALODNER and HASTIE, Circuit Judges.

KALODNER, Circuit Judge.

This is a petition of the Commissioner of Internal Revenue to review a decision of the Tax Court of the United States.

It poses the question whether any part of certain properties held under two trusts created [in 1931] by the settlor-decedent, Charles D. Marshall, a resident

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* Reinecke v. Northern Trust Co., supra page 1143, warned of a constitutional problem if Congress attempted to impose an estate tax on such transfers. In the *Bullard* case, supra page 1180, however, the Supreme Court said: "Since Congress may lay an excise upon gifts it is of no significance that the exaction is denominated an estate tax or is found in a statute purporting to levy an estate tax." Does this rationale dispose of the constitutional doubts expressed in the *Northern Trust Co.* case? Lowndes, The Constitutionality of the New Federal Estate Tax Definition of a Transfer Taking Effect at Death, 3 Vand. L. Rev. 203 (1950).

of Pennsylvania, for his wife, Dora, is includible in his gross estate under Section 811(c)(1)(C) of the [1939] Internal Revenue Code.*

The nub of the controversy is the provision in the trusts that in the event Mrs. Marshall did not exercise granted general powers of appointment the property was to go "to such person or persons as would be entitled thereto under the intestate law of the State of Pennsylvania if she had at that time died seized and possessed of the trust estate," and the fact that under the intestate law of Pennsylvania Marshall would have been entitled to one-third of his wife's estate.

The Tax Court, three judges dissenting, ruled against the inclusion of any part of the trust properties in Mr. Marshall's estate.† In doing so it found . . . that the decedent had not by "express terms" retained a reversionary interest in the trust property and that the reversionary interest, if any, existed by reason of operation of law.

The pertinent facts may be summarized as follows:

Marshall died on May 16, 1945, while a resident of Pennsylvania. He was survived by Mrs. Marshall and six children. . . .

In March, 1931, Marshall created two trusts [providing] that the income from a specified part of each trust should be paid to Mrs. Marshall for life and at her death the trusts were to terminate as to those parts and the trustee was to

> . . . pay over and distribute the same in such manner and in such proportions as she shall by her last will and testament direct, limit, and appoint, and, in default of such appointment, shall pay over and distribute the same to such person or persons as would be entitled thereto under the intestate law of the State of Pennsylvania if she had at that time died seized and possessed of the trust estate.

The intestate law of Pennsylvania in effect at the time of the execution of the two trusts provided that a surviving spouse is entitled to one-third of the estate of a deceased spouse where more than one child or one child and the issue of a deceased child survive.

Mrs. Marshall, on January 26, 1943, relinquished the power of appointment given her by the trust deeds.

The fair market value of Mrs. Marshall's interest in the two trusts at the time of the transfers was [$616,000], and at the date of the decedent's death was [$605,000]. The value of Mrs. Marshall's life interest at the latter date was [$155,000].

The Commissioner originally, in determining the deficiency, included in the gross estate [$450,000] representing the value of the remainder interest after the life estate of Mrs. Marshall in the two trusts. He later . . . at the hearing before the Tax Court, reduced his claim to [$150,000], conceding that the latter was the maximum amount which could have reverted to Marshall under the then (and present) Pennsylvania intestate law.

On this review the Commissioner contends the Tax Court erred in determining (1) the asserted reversionary interest arose by operation of law and not by express terms of the deeds of trust and (2) the indications were that Marshall was not

* Section 811(c)(1)(C), as it stood after enactment of the Technical Changes Act of 1949, contained the postponed-possession-or-enjoyment clause, and §811(c)(2) provided that a transfer intended to take effect in possession or enjoyment at or after the transferor's death was includible (if made on or before October 7, 1949) only if the decedent "retained a reversionary interest in the property, arising by the express terms of the instrument of transfer and not by operation of law, and the value of such reversionary interest immediately before the death of the decedent exceeds 5 per centum of the value of such property." — Ed.

† The Tax Court found that the trusts were intended by Mr. Marshall to compensate his wife and children for certain advances they had made to him in 1930, but this aspect of the case is not presently relevant. — Ed.

thinking of himself and had no intention to retain a reversionary interest. . . .

In reply to the Commissioner's contention the taxpayer asserts that the Tax Court's decision should be affirmed, not only for the reasons which it assigned in its opinion, but also because the necessary survivorship test for includibility under Section 811(c)(1)(C) [1939 Code] is not satisfied.

Upon consideration of the record, the provisions of Section 811 [1939 Code] and their legislative history, we are of the opinion that the Tax Court's decision should be affirmed.

First, we are in accord with the Tax Court's determination that Marshall had not by express terms retained a reversionary interest nor indicated a conscious intent to affect such a retention. Second, we are of the opinion that the necessary survivorship test for includibilty was not met.

On the first score:

It would serve no useful purpose to restate here what has been so well said by the Tax Court in its opinion with reference to its determination that Marshall had not "by express terms" retained a reversionary interest. . . .

It is well-settled that words used in a statute must be considered to have been used by Congress in consonance with the common acceptance of the meaning of such words. Application of that principle to the instant case can have but one result. Section 811(c)(2) provides that "An interest in property of which the decedent made a transfer, on or before October 7, 1949, intended to take effect in possession or enjoyment at or after his death shall not be included in his gross estate . . . unless the decedent has retained a reversionary interest in the property, arising by the *express terms* of the instrument of transfer and not by operation of law. . . ." (Emphasis supplied.) The word "express" means "directly and distinctly stated; expressed, not merely implied or left to inference"; and "that is express which is worded with intention."

Clearly there was not a reservation "by express terms" in the instant case. The Commissioner does not even attempt to argue here that there was a retention of a reversionary interest by express terms. What he does say is that "The decedent, clearly had retained a *possibility* of reverter in the trust corpus." While he ignores the requirement that there must be a retention "by express terms" we, of course, cannot do so. The statute has spelled out the requirement that retention of a reverter must be "by the express terms" and "express" and "possibility" cannot be construed as synonymous by any stretch of the imagination.

On the second score:

As previously stated, the Tax Court based its decision on the fact that there had not been a retention of reverter by "express terms" and for that reason apparently did not consider it necessary to rule on the taxpayer's further contention that the transfers made by Marshall were not "intended to take effect in possession or enjoyment at or after his death" within the meaning of Section 811(c)(1)(C).

The taxpayer has asked us on this review to consider the latter question. The sum and substance of its contention in this respect is that a transfer does not come within Section 811(c)(1)(C) unless the beneficiaries must survive the decedent to obtain possession or enjoyment of the transferred interest and in the instant case if the intestate law had been changed, or if decedent had divorced or failed to support his wife, the beneficiaries could have taken the entire remainder even if they had not survived the decedent.

In our view the taxpayer is correct in its contention that the transfer was not intended to take effect in possession or enjoyment at or after the decedent's death. The "necessary survivorship" rule became part of the Treasury Regulations in 1946, when the so-called "Hallock" regulations were promulgated. Reg. 105, §81.17, T.D. 5512 (1946). As it originally appeared, the rule provided that a

transfer is "intended to take effect in possession or enjoyment at or after his death," and hence the value of the transferred property is includible in the decedent's gross estate, if:

(1) possession or enjoyment of the transferred interest can be obtained only by beneficiaries who *must* survive the decedent . . . (Emphasis supplied.)

The legislative history of the 1949 amendments to section 811(c) indicates clearly that the necessary survivorship rule was to remain undisturbed. The Senate Committee on Finance, in approving the amendments, recognized the rule, and, in its discussion of the bill after it was in its final form the Conference Report states:

. . . The existing rule that a transfer of a property interest is not intended to take effect in possession or enjoyment at or after the decedent's death unless the beneficiaries *must* survive the decedent to obtain possession or enjoyment is not disturbed. (1949-2 Cum. Bull. 295, 298; emphasis supplied.)

The . . . regulations promulgated on March 8, 1951, to implement the 1949 amendments, are to the same effect.*

Undoubtedly then, in determining whether a transferred interest which might revert back to the settlor-decedent was intended to take effect in possession or enjoyment at or after his death, we must inquire whether it was possible, immediately prior thereto for some person who need not have survived him to take that interest. Or, otherwise stated, we must determine whether there was any other contingency, besides the settlor-decedent's death, upon the happening of which his reverter interest would be entirely cut off. If there was, and that contingency was "real," then the transfer was not intended to take effect in possession and enjoyment at or after his death.

At the moment preceding Marshall's death it was possible for beneficiaries to take the one-third interest without surviving him. This could have resulted (1) by a change in the intestate laws of Pennsylvania, mitigating or eliminating the surviving spouse's share; (2) under the present intestate laws if Marshall had divorced his wife or she had divorced him; (3) if Marshall either wilfully neglected or refused to provide for Mrs. Marshall for one year previous to her death, or if he wilfully and maliciously had deserted her for that period. Had any one of those things occurred, the one-third interest which decedent would otherwise have gotten, would have gone to persons (the children, if they survived their mother) who would not have had to survive the decedent.

Nor can these contingencies be disregarded on the ground that they are "unreal." [1] They cannot be regarded as "sham," [2] for, as the Tax Court said:

The indications are that the decedent was not thinking of himself or intending to provide that a part of the trust property was to revert to him and was not to pass to

* Note that the "necessary survivorship" rule is now set out in §2037(a)(1) of the 1954 Code; from 1949 to 1954, it appeared in §811(c)(3), dealing with transfers after October 7, 1949, but not in §811(c)(2), dealing with transfers on or before October 7, 1949. — Ed.

[1] The 1951 Hallock regulations state:

"Where possession or enjoyment of the transferred property can be obtained either by surviving the decedent or through the occurrence of some other event . . . the transfer shall not be considered as intended to take effect in possession or enjoyment at or after the decedent's death *unless, from a consideration of its terms and circumstances as a whole, the other event is deemed to be unreal, in which case such other event shall be disregarded.*" (Emphasis supplied.)

[2] Bittker, in his article "Church and Spiegel: The Legislative Sequel," 59 Yale L.J. 395, 404 (1950), gives the following example of the "unreal" event: ". . . suppose the remainderman were a member of the Communist Party and could take either by becoming President of Yale University or by surviving the settlor. Under the 'Hallock regulation' no doubt the 'other event' would be unreal."

others save upon the condition that he predeceased his wife . . . It seems unlikely that he had it in mind.

The possible contingencies taken together under which beneficiaries could have taken the interest without surviving Marshall cannot be regarded as so remote as to be "unreal."

Thus, there being another event (or events) upon which the beneficiaries could have taken the one-third interest without surviving the decedent, the transfer was not "intended to take effect in possession or enjoyment at or after his (Marshall's) death" and is therefore not includible in Marshall's gross estate.

For the reasons stated the discussion of the Tax Court will be affirmed.

NOTE

1. *The "necessary survivorship" requirement of §2037(a).* Another type of transfer that does not satisfy the "necessary survivorship" rule laid down in the "Hallock regulation" and now set out in §2037(a)(1) of the 1954 Code is this: income to the settlor's wife for her life, remainder to their surviving issue, with a reversion to the settlor or his estate if no issue survive the wife. The "Hallock regulation" did not treat this as a transfer intended to take effect in possession or enjoyment at or after the decedent's death, because the children will take if and only if they are alive when the *life tenant* dies, whether the settlor is still alive or not. Their rights, in other words, are not affected by the settlor's death: if he dies the day after the trust is created, they are no closer to possession or enjoyment than if he were still alive. Thus the transfer is not within the scope of §2037(a)(1), because that clause reaches only those transfers under which "possession or enjoyment of the property can . . . be obtained *only* by surviving the decedent."

During the period from 1940, when the *Hallock* case was decided, to 1946, when the "Hallock regulation" was promulgated, however, a few courts adopted the view that *any* reversionary interest in the settlor required the entire corpus to be included in the gross estate, although the statute said nothing of reversionary interests per se. When this uncritical preoccupation with reversionary interests was at its height, the government seemed to be ready to find a reversionary interest in any trust: if there was a final gift over to a related beneficiary and his estate, it was suggested that the grantor might get the property back by inheritance; if the remainder was left to a charity, it was suggested that the designated charity might not be in existence and that the cy pres doctrine would not be applied, so that the property could revert to the grantor; if the final gift was to the United States (in the hope that no government representative would have the temerity to argue that it might be nonexistent when the remainder was to fall in), the gift might be declined because the estate tax would be larger in amount than the remainder, thus causing a reversion to the grantor; etc. See Looker, Estate Taxation of Living Trusts: The Church and Spiegel Decision, 49 Colum. L. Rev. 437, 447 et seq. (1949). One state intervened (though not until 1949) in aid of the nervous settlor by providing that "if by the terms of the controlling trust instrument the settlor manifested irrevocably his intention to divest himself of all interest" in the property, any interest which otherwise "would be recognized in the settlor of the trust or the estate of the settlor or the heirs at law of the settlor as such . . . shall be deemed to be held upon a resulting trust for the State of Minnesota." Minn. Laws of 1949, c. 201.

Most of the remote reversionary interests that could arise upon failure of issue, dissolution of charities, etc. were not conditioned on survivorship at all, and the fears of cautious conveyancers were calmed when in 1946 the "Hallock regulation" recognized that the only statutory significance of the reversionary interest was that it *might* postpone the beneficiary's possession or enjoyment until the settlor's death. Under this regulation, a reversionary interest was fatal only if it was conditioned on survivorship. Platt, The New Hallock Regulation, 2 Tax L. Rev. 94 (1946). Other reversionary interests were includible in the gross estate under §2033, if not extinguished at death, but only to the extent of their value at the time of death.

When the Supreme Court in the *Church* and *Spiegel* cases stated (supra p. 1216) that a

transfer could not escape the postponed-possession-or-enjoyment clause unless the settlor is left with "no present legal title in the property, no possible reversionary interest in that title, and no right to possess or to enjoy the property then or thereafter," however, it reopened the possibility that any reversionary interest might require inclusion of the entire value of the transferred property. But this possibility was promptly foreclosed by the Technical Changes Act of 1949, which adopted the "necessary survivorship" test of the "Hallock regulation," and this requirement is carried forward by §2037(a)(1).

The transfer described at the beginning of this note, therefore, would not be taxable under §2037. But if the settlor dies before his wife, his estate will possess a possibility of acquiring the property: if when the wife dies no issue survive her, the property will revert to the settlor's estate. The value of this possibility — not the value of the entire corpus — will be included in the settlor's estate under §2033.

2. *Effect of a power of appointment.* When the trust in *Marshall's Estate* were created, Mrs. Marshall was given the power to appoint the corpus; but since she released the power during her husband's lifetime (in 1943), its legal effect was not in issue. Had she not released the power of appointment, the children would have been able to obtain possession and enjoyment of the property if their mother exercised her power of appointment in their favor. If a beneficiary or third party has the power to cut off the decedent's reversionary interest by exercising a general power of appointment, the decedent's death cannot be realistically regarded as a necessary condition to possession or enjoyment. But the Supreme Court held in Goldstone v. United States, 325 U.S. 687 (1945), that at least in some circumstances a reversionary interest was to be counted against the settlor even if it could be destroyed by a beneficiary's power of appointment, and the last sentence of §2037(b) rejects the Court's approach. See Bittker, Church and Spiegel: The Legislative Sequel, 59 Yale L.J. 395, 406-410 (1950). Mrs. Marshall's power was exercisable only by will, and even if not relinquished would probably not have met the standards of the last sentence of §2037(b). But if the grantor's reversionary interest can be destroyed by the exercise of a power of appointment, even if the power does not meet the statutory standard, is the "necessary survivorship" rule of §2037(a)(1) satisfied?

3. *Reversionary power to dispose of property.* The term "reversionary interest" is defined by §2037(b) to include not only a possibility that the property may return to the decedent or his estate, but also a possibility that it may be subject to a "power of disposition by him." What if a trust is created under which the grantor, if he survives the life tenant, will have only a restricted power to affect the remaindermen or other beneficiaries, such as a power to alter the proportion in which they take? See Costin v. Cripe, 235 F.2d 162 (7th Cir. 1956); Klauber's Estate v. Commissioner, 34 T.C. 968 (1960).

In speaking of a possibility that property "may be subject to a power of disposition by him [the decedent]," does §2037(b)(2) contemplate a power exercisable by the decedent alone? In *Klauber's Estate,* supra, the power of disposition was exercisable by a trustee; the court held that it was in affect exercisable by the decedent because he could have removed the trustee and appointed someone amenable to his wishes.

4. *Valuing the reversionary interest in applying the 5 per cent rule.* Even if both questions in the *Marshall's Estate* case had been answered adversely to the taxpayer, it would still have been necessary to determine if the value of the reversionary interest immediately before the death of the decedent exceeded 5 per cent of the value of the property. The ages of Mr. and Mrs. Marshall are not given in the reports, and this information would be essential in determining if his chance of surviving his wife was worth more than 5 per cent of $200,000. (See Regs. §20.2037-1(c)(4), to the effect that the value of the reversionary interest is compared with the value of the transferred property, "including interests therein which are not dependent upon survivorship of the decedent.") For more on the problem of valuing reversionary interests, see page 1228 infra.

5. *Relinquishment of reversionary interest in contemplation of death.* If the grantor of a trust finds that he possesses a reversionary interest that may be worth more than 5 per cent of the corpus when he dies, would a release or assignment of the unwanted interest during his lifetime be a gift in contemplation of death? If so, is the value of the entire corpus includible or only the value of the interest? This problem was considered earlier in connection with a release of a retained life estate to avoid the estate tax. See United States v. Allen, supra page 1198.

6. *Reference.* Covey, The Klauber Case and Sections 2036(a)(1), 2037 and 2038 of the 1954 Code, 5 Tax Couns. Q. 129 (1961).

SMITH v. SHAUGHNESSY
318 U.S. 176 (1943)

MR. JUSTICE BLACK delivered the opinion of the Court.

The question here is the extent of the petitioner's liability for a tax under [§2511(a)], which imposes a tax upon every transfer of property by gift, "whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; . . ."

The petitioner, age 72, made an irrevocable transfer in trust of 3,000 shares of stock worth $571,000. The trust income was payable to his wife, age 44, for life; upon her death, the stock was to be returned to the petitioner, if he was living; if he was not living, it was to go to such persons as his wife might designate by will, or in default of a will by her, to her intestate successors under applicable New York law. The petitioner, under protest, paid a gift tax of $71,674.22, assessed on the total value of the trust principal, and brought suit for refund in the district court. Holding that the petitioner had, within the meaning of the Act, executed a completed gift of a life estate to his wife, the court sustained the Commissioner's assessment on $322,423, the determined value of her life interest; but the remainder was held not to be completely transferred and hence not subject to the gift tax. 40 F. Supp. 10. The Government appealed and the Circuit Court of Appeals reversed, ordering dismissal of the petitioner's complaint on the authority of its previous decision in Herzog v. Commissioner, 116 F.2d 591. We granted certiorari because of alleged conflict with our decisions in Helvering v. Hallock [supra p. 1213], and Sanford v. Commissioner [supra p. 1150]. In these decisions, and in Burnet v. Guggenheim [supra p. 1007], we have considered the problems raised here in some detail, and it will therefore be unnecessary to make any elaborate re-survey of the law.

Three interests are involved here: the life estate, the remainder, and the reversion. The taxpayer concedes that the life estate is subject to the gift tax. The Government concedes that the right of reversion to the donor in case he outlives his wife is an interest having value which can be calculated by an actuarial device, and that it is immune from the gift tax. The controversy, then, reduces itself to the question of the taxability of the remainder.

The taxpayer's principal argument here is that under our decision in the *Hallock* case, the value of the remainder will be included in the grantor's gross estate for estate tax purposes; and that in the *Sanford* case we intimated a general policy against allowing the same property to be taxed both as an estate and as a gift.

This view, we think, misunderstands our position in the *Sanford* case. As we said there, the gift and estate tax laws are closely related and the gift tax serves to supplement the estate tax.[1] We said that the taxes are not "always mutually exclusive," and called attention to [§2012], which charts the course for granting credits on estate taxes by reason of previous payment of gift taxes on the same property. The scope of that provision we need not now determine. It is sufficient to note here that Congress plainly pointed out that "some" of the "total gifts subject to gift taxes . . . may be included for estate tax purposes and some

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1 The gift tax was passed not only to prevent estate tax avoidance, but also to prevent income tax avoidance through reducing yearly income and thereby escaping the effect of progressive surtax rates. House Report No. 708, 72d Cong., 1st Sess., p. 28; Brandeis, J., dissenting in Untermyer v. Anderson, 276 U.S. 440, 450; Stone, J., dissenting in Heiner v. Donnan, 285 U.S. 312, 333.

not." House Report No. 708, 72d Cong., 1st Sess., p. 45. Under the statute the gift tax amounts in some instances to a security, a form of down-payment on the estate tax which secures the eventual payment of the latter; it is in no sense double taxation as the taxpayer suggests.

We conclude that under the present statute, Congress has provided as its plan for integrating the estate and gift taxes this system of secured payment on gifts which will later be subject to the estate tax.[2]

Unencumbered by any notion of policy against subjecting this transaction to both estate and gift taxes, we turn to the basic question of whether there was a gift of the remainder. The government argues that for gift tax purposes the taxpayer has abandoned control of the remainder and that it is therefore taxable, while the taxpayer contends that no realistic value can be placed on the contingent remainder and that it therefore should not be classed as a gift.

We cannot accept any suggestion that the complexity of a property interest created by a trust can serve to defeat a tax. For many years Congress has sought vigorously to close tax loopholes against ingenious trust instruments. Even though these concepts of property and value may be slippery and elusive they can not escape taxation so long as they are used in the world of business. The language of the gift tax statute, "property . . . real or personal, tangible or intangible," is broad enough to include property, however conceptual or contingent. And lest there be any doubt as to the amplitude of their purpose, the Senate and House Committees, reporting the bill, spelled out their meaning as follows:

> The terms "property," "transfer," "gift," and "indirectly" [in §2511(a)], are used in the broadest and most comprehensive sense; the term "property" reaching every species of right or interest protected by law and having an exchangeable value.

The essence of a gift by trust is the abandonment of control over the property put in trust. The separate interests transferred are not gifts to the extent that power remains to revoke the trust or recapture the property represented by any of them, Burnet v. Guggenheim, supra, or to modify the terms of the arrangement so as to make other disposition of the property, Sanford v. Commissioner, supra. In the *Sanford* case the grantor could, by modification of the trust, extinguish the donee's interest at any instant he chose. In cases such as this, where the grantor has neither the form nor substance of control and never will have unless he outlives his wife, we must conclude that he has lost all "economic control" and that the gift is complete except for the value of his reversionary interest.

The judgment of the Circuit Court of Appeals is affirmed with leave to the petitioner to apply for modification of its mandate in order that the value of the petitioner's reversionary interest may be determined and excluded.

It is so ordered.

MR. JUSTICE ROBERTS.

I dissent. I am of opinion that, except for the life estate in the wife, the gift qua the donor was incomplete and not within the sweep of [§2511(a)]. A contrary conclusion might well be reached were it not for Helvering v. Hallock, 309 U.S. 106. But the decision in Burnet v. Guggenheim, 288 U.S. 280, and Sanford v. Commissioner, 308 U.S. 39, to which the court adheres, requIre a reversal in view of the ruling in the *Hallock* case.

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[2] It has been suggested that the congressional plan relating the estate and gift taxes may still be incomplete. See e.g., Griswold, "A Plan for the Coordination of the Income, Estate, and Gift Tax Provisions, etc.," 56 Harv. L. Rev. 337; Magill, "The Federal Gift Tax," 40 Col. L. Rev. 773, 792; Kauper, "The Revenue Act of 1942: Estate and Gift Tax Amendments," 41 Mich. L. Rev. 369, 388; and see Commissioner v. Prouty, 115 F.2d 331, 337; Higgins v. Commissioner, 129 F.2d 237, 239.

The first of the two cases ruled that a transfer, in trust whereby the grantor reserved a power of revocation, was not subject to a gift tax, but became so upon the renunciation of the power. The second held that where the grantor reserved a power to change the beneficiaries, but none to revoke or to make himself a beneficiary, the transfer was incomplete and not subject to gift tax. At the same term, in Porter v. Commissioner, 288 U.S. 436, the court held that where a decedent had given property inter vivos in trust, reserving a power to change the beneficiaries but no power to revoke or revest the property in himself, the transfer was incomplete until the termination of the reserved power by the donor's death and hence the corpus was subject to the estate tax.

When these cases were decided, the law, as announced by this court, was that where, in a complete and final transfer inter vivos, a grantor provided that, in a specified contingency, the corpus should pass to him, if living, but, if he should be dead, then to others, the gift was complete when made, he retained nothing which passed from him at his death, prior to the happening of the contingency, and that no part of the property given was includible in his gross estate for estate tax. McCormick v. Burnet, 283 U.S. 784; Helvering v. St. Louis Union Trust Co., 296 U.S. 39; Becker v. St. Louis Union Trust Co., 296 U.S. 48. So long as this was the law the transfer might properly be the subject of a gift tax for the gift was, as respects the donor, complete when made.

In 1940 these decisions were overruled [by *Hallock*, supra p. 1213] and it was held that such a transfer was so incomplete when made, and the grantor retained such an interest, that the cessation of that interest at death furnished the occasion for imposing an estate tax. Thus the situation here presented was placed in the same category as those where the grantor had reserved a power to revoke or a power to change beneficiaries. By analogy to the *Guggenheim* and *Sanford* cases, I suppose the gift would have become complete if the donor had, in his life, relinquished or conveyed the contingent estate reserved to him.

In the light of this history, the *Sanford* case requires a holding that the gifts in remainder, after the life estate, create no gift tax liability. The reasoning of that decision, the authorities, and the legislative history relied upon, are all at war with the result in this case. There is no need to quote what was there said. A reading of the decision will demonstrate that, if the principles there announced are here observed, the gifts in question are incomplete and cannot be the subject of the gift tax.

It will not square with logic to say that where the donor reserves the right to change beneficiaries, and so delays completion of the gift until his death or prior relinquishment of the right, the gift is incomplete, but where he reserves a contingent interest to himself the reverse is true,— particularly so, if the criterion of estate tax liability is important to the decision of the question, as the *Sanford* case affirms.

The question is not whether a gift which includes vested and contingent future interests in others than the donor is taxable as an entirety when made, but whether a reservation of such an interest in the donor negatives a completion of the gift until such time as that interest is relinquished.

All that is said in the *Sanford* case about the difficulties of administration and probable inequities of a contrary decision there, applies here with greater force. Indeed a system of taxation which requires valuation of the donor's retained interest, in the light of the contingencies involved, and calculation of the value of the subsequent remainders by resort to higher mathematics beyond the ken of the taxpayer, exhibits the artificiality of the Government's application of the Act. This is well illustrated in the companion cases of *Robinette* and *Paumgarten.*

Such results argue strongly against the construction which the court adopts.

ROBINETTE v. HELVERING

318 U.S. 184 (1943)

MR. JUSTICE BLACK delivered the opinion of the Court.

This is another case under [§2511(a)], which, while presenting certain variants on the questions decided in Smith v. Shaughnessy, is in other respects analogous to and controlled by that case.

In 1936, the petitioner, Elise Paumgarten (nee Robinson), was thirty years of age and was contemplating marriage; her mother, Meta Biddle Robinette, was 55 years of age and was married to the stepfather of Miss Robinson. The three, daughter, mother and stepfather, had a conference with the family attorney, with a view of keeping the daughter's fortune within the family. An agreement was made that the daughter should place her property in trust, receiving a life estate in the income for herself, and creating a second life estate in the income for her mother and stepfather if she should predecease them. The remainder was to go to her issue upon their reaching the age of 21, with the further arrangement for the distribution of the property by the will of the last surviving life tenant if no issue existed. Her mother created a similar trust, reserving a life estate to herself and her husband and a second or contingent life estate to her daughter. She also assigned the remainder to the daughter's issue. The stepfather made a similar arrangement by will. The mother placed $193,000 worth of property in the trust she created, and the daughter did likewise with $680,000 worth of property.

The parties agree that the secondary life estates in the income are taxable gifts, and this tax has been paid. The issue is whether there has also been a taxable gift of the remainders of the two trusts. The Commissioner determined that the remainders were taxable, the Board of Tax Appeals reversed the Commissioner, and the Circuit Court of Appeals reversed the Board of Tax Appeals. 129 F.2d 832.

The petitioners argue that the grantors have not relinquished economic control and that this transaction should not be subject both to the estate and to the gift tax. What we have said in the *Smith* case determines these questions adversely to the petitioners. However, the petitioners emphasize certain other special considerations.

First. Petitioners argue that since there were no donees in existence on the date of the creation of the trust who could accept the remainders, the transfers cannot be completed gifts. The gift tax law itself has no such qualifications. It imposes a tax "upon the transfer . . . of property by gift." And Treasury Regulations [§25.2511-2(a)] provide that "The tax is a primary and personal liability of the donor, is an excise upon his act of making the transfer, is measured by the value of the property passing from the donor, and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable." We are asked to strike down this regulation as being invalid because inconsistent with the statute. We do not think it is. As pointed out in the *Smith* case, the effort of Congress was to reach every kind and type of transfer by gift. The statute "is aimed at transfers of the title that have the quality of a gift." Burnet v. Guggenheim, 288 U.S. 280, 286. The instruments created by these grantors purported on their face wholly to divest the grantors of all dominion over the property; it could not be returned to them except because of contingencies beyond their control. Gifts of future interests are taxable under [§2503(b)], and they

do not lose this quality merely because of the indefiniteness of the eventual recipient. The petitioners purported to give the property to someone whose identity coud be later ascertained and this was enough.

Second. It is argued that the transfers were not gifts but were supported by "full consideration in money or money's worth." This contention rests on the assumption that an agreement between the parties to execute these trusts was sufficient consideration to support the transfers. We need not consider or attempt to decide what were the rights of these parties as among themselves. Petitioners think that their transaction comes within the permissive scope of Regulations [§25.2512-8] which provides that "a sale, exchange, or other transfer of property made in the ordinary course of business (a transaction which is bona fide, at arm's length, and free from any donative intent) will be considered as made for an adequate and full consideration in money or money's worth." The basic premise of petitioner's argument is that the moving impulse for the trust transaction was a desire to pass the family fortune on to others. It is impossible to conceive of this as even approaching a transaction "in the ordinary course of business."

Third. The last argument is that "in any event, in computing the value of the remainders herein, allowance should be made for the value of the grantor's reversionary interest." Here, unlike the *Smith* case, the government does not concede that the reversionary interest of the petitioner should be deducted from the total value. In the *Smith* case, the grantor had a reversionary interest which depended only upon his surviving his wife, and the Government conceded that the value was therefore capable of ascertainment by recognized actuarial methods. In this case, however, the reversionary interest of the grantor depends not alone upon the possibility of survivorship but also upon the death of the daughter without issue who should reach the age of 21 years. The petitioner does not refer us to any recognized method by which it would be possible to determine the value of such a contingent reversionary remainder. It may be true, as the petitioners argue, that trust instruments such as these before us frequently create "a complex aggregate of rights, privileges, powers and immunities and that in certain instances all these rights, privileges, powers and immunities are not transferred or released simultaneously." But before one who gives his property away by this method is entitled to deduction from his gift tax on the basis that he had retained some of these complex strands it is necessary that he at least establish the possibility of approximating what value he holds. Factors to be considered in fixing the value of this contingent reservation as of the date of the gift would have included consideration of whether or not the daughter would marry; whether she would have children; whether they would reach the age of 21; *etc.* Actuarial science may have made great strides in appraising the value of that which seems to be unappraisable, but we have no reason to believe from this record that even the actuarial art could do more than guess at the value here in question. Humes v. United States, 276 U.S. 487, 494.

The judgment of the Circuit Court of Appeals is affirmed.

MR. JUSTICE ROBERTS dissents for the reasons set forth in his opinion in Smith v. Shaughnessy.

NOTE

1. *Value of reversionary interest in applying 5 per cent rule of §2037.* Section 2037(b) of the estate tax law states that in applying the 5 per cent test, the value of a reversionary interest shall be determined "by usual methods of valuation, including the use of tables of mortality and actuarial principles." The Conference Committee's report on the

Technical Changes Act of 1949, in recommending adoption of the 5 per cent rule, stated:

> The value [of a reversionary interest] shall be ascertained as though the decedent were, immediately before his death, making a gift of the property and retaining the reversionary interest. The rule of Robinette v. Helvering (318 U.S. 184), under which a reversionary interest not having an ascertainable value under recognized valuation principles is considered to have a value of zero, is to apply. [H.R. Rept. No. 1412, 81st Cong., 1st Sess., 1949-2 C.B. 295, 297.]

Why should valuation of reversionary interests, under the 5 per cent rule, be governed by the same principles that are applied in valuing such interests for the gift tax?

The Senate Report on the 1954 Code states:

> The decedent's reversionary interest is to be valued by recognized valuation principles and without regard to the fact of the decedent's death. Where it is apparent from the facts that property could have reverted to the decedent under contingencies that were not remote, the reversionary interest is not to be necessarily regarded as having no value merely because the value thereof cannot be measured precisely.* [S. Rept. No. 1622, 83d Cong., 2d Sess. 469.]

If the reversionary interest's value cannot be determined by recognized principles of valuation, is it to be treated as having no value, as the 1949 Conference Report states, — or does the 1954 Senate Report mean that it will be treated as worth more than 5 per cent because the taxpayer will be unable to prove that it is worth less? In Estate of Thacher v. Commissioner, 20 T.C. 474 (1953), property would revert to the decedent if his wife was divorced or legally separated from him. Because there was no evidence that the value of the reversionary interest could not be measured, the court held that it had to assume that the value of the interest exceeded 5 per cent of the value of the property. Can this conclusion be reconciled with the 1949 Conference Report? The case was decided in 1953. If it had come up after the 1954 Senate Report, would the reversionary interest be fatal even if there was evidence that its value could not be calculated by recognized valuation methods? See also Cardeza's Estate v. United States, 261 F.2d 423 (3d Cir. 1958) (reversionary interest in decedent contingent on son's death without issue; held, in view of financial incentive to son's having issue, no value can be reliably ascribed to decedent's reversionary interest and, under 1939 Code, it must be treated as having value of zero).

2. *Possibility of invasion of corpus for decedent's benefit.* What is the relation between the 5 per cent rule and cases like Blunt v. Kelly, supra page 1164? Under these cases, part or all of the corpus of a trust was included in the grantor's estate because he had the right to compel the trustee to make distributions to him on the occurrence of specified events. If the possibility is such that the 5 per cent rule would not be satisfied, are these cases (which arose under the old postponed-possession-or-enjoyment clause) still valid?

In Holtz's Estate v. Commissioner, supra page 1013, the decedent had reserved the right to receive the income from the transferred property, as well as such amounts of the principal as the trustee "may from time to time think desirable for the welfare, comfort and support of Settlor, or for his hospitalization or other emergency needs." If he had not retained the right to the income, would the corpus be includible in his gross estate under §2037?

3. *Gift tax when trustee is to pay settlor's income taxes.* Harrison v. Commissioner, 17 T.C. 1350 (1952), involved the valuation, for gift tax purposes, of a trust under which the trustee was required to pay the settlor's federal and state income taxes. The Com-

* In Summary of the New Provisions of the Internal Revenue Code of 1954 (1955), prepared by the Joint Committee on Internal Revenue Taxation, the 5 per cent rule is described as follows: "The 1954 Code provides that property previously transferred by a decedent is to be includible in his estate only if he still has (either expressly or by operation of law) immediately before his death a reversionary interest in the property exceeding 5 per cent of its value. The reversionary interest will be valued by actuarial methods so that a mere expectancy will have no value, whether or not it could be considered a reversionary interest." (P. 113.) — Ed.

missioner contended that in computing the amount subject to gift tax no allowance could be made for the settlor's reservation of the right to have her income taxes paid by the trustee because the value of that right was not ascertainable with the accuracy required by the *Robinette* case. The court held:

> It is, of course, impossible to foretell with mathematical accuracy the amount of the future Federal and state income taxes which have to be paid under the terms of the trust agreement within the lifetime of petitioner. However, of a certainty, we know that some tax payments will be required. Since the adoption of the Sixteenth Amendment to the Constitution, Federal income taxes have become a permanent and growing part of our economy, and there is no likelihood that such taxes will not continue to be imposed throughout the life expectancy of petitioner. Even though difficult to ascertain, an estimate of petitioner's present right to have her future income tax paid should be made. [17 T.C. at 1354-1355.]

An estimate was more feasible in the *Harrison* case than it would be in many circumstances, since the taxpayer had transferred all of her income-producing property into the trust and had retained only the right to receive $12,000 per year therefrom (plus an amount to discharge her income taxes); the value of the right to have her income taxes paid was apparently estimated by the court on the assumption that federal and state taxes would continue for the settlor's life expectancy to be very nearly what they were when the trust was created. (For another aspect of this case, see page 1012 supra.)

FEDERAL ESTATE AND GIFT TAXES: A PROPOSAL FOR INTEGRATION AND FOR CORRELATION WITH THE INCOME TAX

Joint Study of Advisory Committee to the Treasury Department and by Office of Tax Legislative Counsel 22-24 (1947)

2. *Dispositions Reserving a Reversionary Interest in the Transferor*

Under this heading the following provisions are recommended:

(a) A transfer shall be deemed incomplete if the property or the income therefrom must revert to the transferor or his estate after the expiration of any period of time;

(b) A transfer shall be deemed incomplete if the property or the income therefrom may so revert to the transferor or his estate and no beneficiary can obtain possession or enjoyment of the property during the transferor's lifetime.

These suggestions for change require a brief explanation of existing law.

If a transferor at the present time [1947], in making an inter vivos disposition of property, provides that the property is to return to him or his estate after a specified period of time, a gift tax is imposed upon the value of the interests granted to others. If the property does not revert to him prior to his death, an estate tax is imposed upon the value of the reversion at the date of death. If there is a similar reversionary interest only in the income, the actuarial value of such lesser interest is taxable at death. The draft accompanying this report would withhold the imposition of any transfer tax until death unless the reversionary interest were released before death. There are two reasons which suggest the appropriateness of the recommendations. First, a transfer tax should strive as much as possible, for the sake of simplicity in application and convenience of administration, to apply at one particular time to a disposition as a whole. One might say that such single application is of the very essence of an integrated transfer tax. If tax is imposed at several stages, difficulties are bound to arise, especially with regard to the valuation of interests preceding the reversion. Secondly, the recommendation follows very naturally from the income tax treatment

proposed with respect to the same type of transfer. Since it was felt that income tax should be imposed upon the transferor, a suggestion that such a transfer be treated as a completed gift was rejected. The considerations for imposition of income tax upon the transferor in this connection are noted more fully below in describing the income tax recommendations.

A problem of much greater importance under the existing estate and gift taxes is presented by a reversionary interest in the grantor or his estate which is contingent in character. Such an interest arises where the property may or may not return to the grantor, depending upon whether or not he survives the income beneficiaries. The gift tax consequences where such a reversionary interest is present are generally clear. A gift tax is payable upon the value of the entire property less the value of the reversionary interest (Smith v. Shaughnessy [supra p. 1224]), or upon the value of the entire property if the reversionary interest cannot be valued according to recognized actuarial methods of computation (Robinette v. Helvering [supra p. 1227]). If the property is thereafter included in the gross estate at the transferor's death, a credit is allowed for the gift tax paid.

The situation under the estate tax was obscure for a long time. The recent regulations have, however, cleared the air of much of the confusion surrounding transfers with reserved reversionary interests. See Reg. 105, section 81.17 [supra p. 1220]. Under the regulations, if a transferor provides that the property is to return to him if he is living at the death of the income beneficiaries, the value of the property, less the value of any outstanding life estates in others, is includible in the gross estate. The typical situation is one in which the transferor provides for a life estate in his wife, a remainder to their children if he predeceases his wife, and a reversion to him if he survives her. Inasmuch as the ultimate receipt of the remainder is dependent upon the beneficiaries' survival of the transferor, it is taxable under section 811(c) of the 1939 Code* as a transfer intended to take effect in possession or enjoyment at or after the transferor's death. Helvering v. Hallock, 309 U.S. 106 (1940). On the other hand, where the passing of a remainder interest is not dependent upon the transferor's death, such interest is not subjected by the regulations to an estate tax despite the transferor's reservation of a reversion. Such a case may be illustrated by a transfer in trust providing for a life estate in the transferor's wife, a remainder to their surviving issue, and a reversion to the transferor or his estate in the absence of such issue.

The foregoing principles have provided the basis for the recommendation made with respect to contingent reversionary interests. Under the proposed provision, where the transferor reserves such an interest, the basic question is whether any beneficiary can obtain possession or enjoyment of the property during the transferor's lifetime. If the answer is in the affirmative, the entire property is subjected to transfer tax at the time of transfer. If the answer is in the negative, the transfer tax is postponed until death. In neither case is allowance made for the value of the reversion or of any outstanding life estates. In this manner there is but one taxable event and difficult problems of valuing "slippery and elusive" interests are avoided. Cf. Smith v. Shaughnessy, 318 U.S. 176, 180 (1943). Although such problems could be avoided by treating all transfers with contingent reversionary interests as completed gifts, this approach was rejected for two reasons. First, since transfers of the *Hallock* variety suspend the ultimate possession of the property until the grantor's death, they are essentially death transfers of the property. Secondly, the adoption of such a rule would create an avenue of income tax avoidance through the use of contingent reverters which

* I.e., before the 5 per cent rule was enacted by the Technical Changes Act of 1949. — Ed.

would almost certainly vest in the grantor prior to death. On the other hand, dispositions under which the property can be obtained while the transferor is living do not constitute dispositions at death and are accordingly treated as completed transfers. It is of course possible, as in the case of a *Hallock* transfer, to utilize such a disposition as a means of escaping the income tax on the transferred property and at the same time assuring the return of the property. The fact that a second transfer tax on the entire property would be payable when the transferor redisposes of the property which has come back to him, however, will tend to discourage such devices.

NOTE

How does this proposal differ from the treatment provided by the 1954 Code? Which is preferable, in your opinion?

SECTION F. SURVIVORSHIP ANNUITIES: §2039

1. *Purchased Commercial Annuities*

Section 2039, governing the taxability of survivorship annuities, was added to the Internal Revenue Code in 1954. Before 1954, the value of the rights of a beneficiary under a survivorship annuity was included in the gross estate of the purchaser of the annuity contract only if the transaction could be fitted into some other provision of the estate tax law. To see the 1954 statute in perspective, it is necessary to sketch in the background.

Suppose A purchases a commercial annuity contract under which he will receive $5000 a year for his life and his wife, if she survives him, will receive the same (or lesser) amount for her life. This is a "self and survivor" contract. Disregarding the insurance company's expenses and profit, A's purchase of the contract might be compared to a transfer of property in trust, under which A is to receive (a) the income for life, plus (b) part of the corpus each year, if necessary to bring his return up to $5000 per year. Since a transfer in trust with reservation of the income for life is taxable under §2036 (unless the transfer was made on or before March 3, 1931), A's annuity contract would also seem to be includible under §2036. The parallel is not perfect, to be sure, since A is entitled to receive $5000 per year under the contract, but no more; if instead of buying the contract he had transferred an equal amount in trust with a reservation of the income, his return in any one year might exceed $5000. But the cost of A's annuity is based on the assumption that A for his life, and then his wife for hers, will not only get the income produced by the funds paid for the annuity, but also returns to capital. At one time it was argued that the purchaser of such an annuity contract had not "retained" possession or enjoyment of any property or the income therefrom, as required by §2036, because the consideration he paid for the contract was entirely at the disposal of the insurance company. The courts finally adopted the view, however, that the value of the wife's rights under such a contract, measured at the time of the purchaser's death, was includible under what is now §2036. Commissioner v. Clise, 122 F.2d 998 (9th Cir. 1941), cert. denied, 315 U.S. 821 (1942); Forster v. Sauber, 249 F.2d 379 (7th Cir. 1957); see also Welliver's Estate v. Commissioner, 8 T.C. 165, 172 (1947) (beneficiary's rights valued at the cost of obtaining a contract for her at time of decedent's death, even if greater than the part of the cost of the original contract attributable to her rights). Of course, if the wife predeceases the husband, the insurance

company's obligation to make payments would terminate at the husband's death and there would be no value to be included in his gross estate.

Another common annuity contract provides for payments to both the purchaser and his wife while they both live, with payments continuing to the survivor (a "joint and survivor" annuity). Suppose A is to get $2500 and his wife a like amount while they both live, and the survivor is to receive $5000 for life. If A predeceases his wife, can the value of her rights at the time of his death be taxed to his estate under §2036? It is of course possible that A's $2500 per year during his wife's life was substantially less than the income that would have been produced if the purchase price of the annuity had been transferred in trust. Does this destroy the analogy suggested earlier? Even if it does, recall that in Marks v. Higgins, supra page 1192, a transfer under which the grantor reserved a "contingent" life estate was held to be within §2036. Does not A, under the joint and survivor annuity, have at least the equivalent of a contingent life estate, namely, his right to receive $5000 per year should he survive his wife? Such annuities were held to be taxable under what is now §2036. Mearkle's Estate v. Commissioner, 129 F.2d 386 (3d Cir. 1942).

Section 2039 of the 1954 Code now takes over from §2036 the responsibility for such annuities as these. Accepting the analogy of transfers with reserved life estates, §2039 applies (like §2036) only to transactions after March 3, 1931, and the last clause of §2039(a) is adopted verbatim from §2036(a).* The House version of §2039 required that "an annuity or similar payment" be payable to the decedent; the Senate changed this phrase to "an annuity or other payment" to make it clear that §2039 applied if the decedent could get a lump-sum payment in lieu of an annuity. (S. Rept., p. 470). Note that §2039(a) is applicable if "an annuity or other payment *was payable* to the decedent, or the decedent *possessed the right to receive such annuity or payment.*" (Emphasis supplied.) Is there a difference between an annuity that was "payable" to the decedent and one that he "possessed the right to receive"? Is §2039 applicable if the decedent's *wife* was to receive the annuity for her life and he was to receive payments only if he survived her? Suppose A, instead of buying a "self and survivor" annuity, buys two contracts: an annuity for himself; and one for his wife under which payments are to be made only if she survives him. Is §2039 applicable?

The Senate Report states (p. 472) that the provisions of §2039 "shall not prevent the application of any other provision of law relating to the estate tax." Consider these possibilities:

1. Could an annuity contract purchased on or before March 3, 1931, be reached by §2037? Under the "self and survivor" contract, the wife gets nothing unless she survives A. Does this meet the requirement of §2037(a)(1)? If A lives long enough his wife will get nothing. Does this mean that he has a "reversionary interest" within the meaning of §2037(a)(2)? In Pruyn's Estate v. Commissioner, 184 F.2d 971 (2d Cir. 1950), it was held that the purchaser of a "self and survivor" contract does not have a reversionary interest as that term is used in what is now §2037(a). In Commissioner v. Wilder's Estate, 118 F.2d 281 (5th Cir. 1941), however, the court held that the wife's rights under a "self and survivor" contract are intended to take effect in possession or enjoyment on her husband's death, which may mean that the court thought the purchaser had a reversionary interest. If A buys a "joint and survivor" contract under which he and his wife will each get $2500 while they both live, and the survivor will then

* In taking over this language from §2036(a), the draftsman seems to have overlooked the fact that it came into the statute in 1932 rather than in 1931. Supra page 1179. Section 2036(b) recognizes the difference between the Joint Resolution of March 3, 1931, and the amendment of June 6, 1932, but §2039, although it uses March 3, 1931, as a dividing date, does not.

get $2500 for life, is §2037(a)(1) satisfied? What if the survivor's annuity is to increase to $5000 on A's death, and A dies first?

2. If §2039 is inapplicable, either because the decedent had no right to receive payments himself or because the contract was purchased on or before March 3, 1931, would §2038 be applicable if the decedent reserved a power to alter or amend the beneficiary's rights?

3. If A buys an annuity contract for his wife, and dies within three years, could the purchase be treated as a gift in contemplation of death under §2035?

4. If the decedent purchased an annuity for himself alone, with no provision for payments to a survivor, §2039 is inapplicable, and there is no value at the date of death to be included under any other provision. But if such a contract provides for a refund to the purchaser's estate if he dies before receiving a specified number of payments (e.g., as in the *Egtvedt* case, supra p. 150), §2033 would reach the refund. If the refund is payable to a named beneficiary rather than to the purchaser's estate, apparently §2039 would be applicable.

5. If the purchaser of an annuity contract had, until his death, the power to surrender the contract for cash, would the amount he could obtain just before his death by a surrender of the contract be taxable under §2033?

6. A buys a contract providing an annuity for his wife, who is younger than he. His only right under the contract is that he or his estate will receive a refund if his wife should die before her receipts under the contract equal the price he paid for it. A dies before his wife has received back the cost of the contract. Is anything includible in A's estate? Note that if A's wife lives out her life expectancy, there will be no refund. Would the answer depend upon the estate of Mrs. A's health when A dies? See Hofford v. Commissioner, 4 T.C. 542, 556-557 (1945).

The income tax status of annuities was dealt with supra pages 153-154. A portion of the payments under an annuity contract may be excluded from gross income under §72(b) as a return of capital, but the balance constitutes taxable income by virtue of §72(a). In the case of a survivorship annuity, the exclusion determined under §72(b) is available throughout the contract period, i.e., the primary annuitant is entitled to exclude part of each payment until death and the survivor annuitant excludes a similar portion during his or her life. But §2039 requires the value of the survivor's rights under the contract to be included in the purchaser's gross estate, and the estate tax value may exceed the aggregate amount which the survivor would be entitled to treat as a return of capital under §72(b). For this reason, §691(d) permits the survivor, in the case of a joint and survivor annuity, to deduct an appropriate portion of the estate tax as the payments under the contract come in. The complex relation between the income tax and the estate tax is illustrated by an example in Forster and Frost, Changes in Taxation of Life Insurance, Endowment, and Annuity Contracts, 1955 So. Calif. Tax Inst. 557, 584-585. Does §691(d) offer any relief in the case of "self and survivor" annuities?

2. *Employee Annuities*

As the foregoing material indicates, the taxable status of typical joint and survivor annuities was moderately clear even before the enactment of §2039 in 1954, and the minor unsettled issues are still in doubt. In point of fact, however, the primary function of the new section was to clear up the status of survivorship annuities purchased by employers for their employees. The Senate Report states (p. 123):

> Under present [pre-1954] law the value at the decedent's death of a joint and survivor annuity purchased by him is includible in his gross estate. It is not clear under existing

law whether an annuity of that type purchased by the decedent's employer, or an annuity to which both the decedent and his employer made contributions is includible in the decedent's gross estate.*

BAHEN'S ESTATE v. UNITED STATES

305 F.2d 827 (Ct. Cl. 1962)

DAVIS, Judge.

The estate of a former high-ranking officer of The Chesapeake and Ohio Railway Company claims that sums paid by the C. & O. to his widow on his death in 1955, under benefit plans unilaterally adopted by the railroad in 1952 and 1953, were improperly included in his gross estate for tax purposes. The issue is one of law under the Internal Revenue Code of 1954; the parties have agreed upon a stipulation of facts which we have accepted.

The decedent, J. William Bahen, was born in 1905 and died in 1955. He married the plaintiff, executrix of the estate, in 1930; they had no children. For almost 37½ years Mr. Bahen worked continuously for the C. & O.; at his death he was the fulltime Assistant to the President. He had not retired nor was he eligible for retirement. . . .

After Mr. Bahen's death, the C. & O. made payments to his widow under two plans which it had earlier established for its employees. The first was the Death Benefit Plan, adopted in January 1952, which provided (see finding 9) that, if a covered employee with more than 10 years' service died while in the company's employ and before becoming eligible for retirement, the C. & O. would pay, "in recognition of the services rendered by him," a sum equal to three months' salary to his widow or (if she died prior to payment) to the guardian of any of his minor children.

The more significant arrangement was the Deferred Compensation Plan adopted by the company in February 1953 for forty of its officers and executives. See finding 6. For a designated officer who was under 60 at that time, like Mr. Bahen, the C. & O. would pay a stated maximum sum ($100,000 in Mr. Bahen's case), at his death either before or after retirement, to his widow and to those of his surviving children under 21 the officer might specify (and in the propor-

* For a summary of the pre-1954 law, see Bittker, Estate and Gift Taxation Under the 1954 Code: The Principal Changes, 4 U. of Denver Tax Inst. 140 (1954), also in 29 Tul. L. Rev. 453 (1955):

"A . . . difficult problem under the pre-1954 law was created by employee annuities paid or financed by employers. If an employee, in an effort to provide financial security for his wife after his death, bargained with his employer for an increased salary, and used the increased wages to purchase a joint and survivor annuity contract, the survivor's rights under the contract were treated like similar rights under any other purchased annuity contract. But if instead of increasing wages, the employer agreed to provide an annuity upon retirement, with payments to be made to the wife upon the employee's death, the pre-1954 law was far less clear. Since such retirement annuities were customarily payable only if the employee had not died, quit, or been discharged for cause before the retirement date set in the employer's plan, there was some doubt as to whether the employee had any 'property' to transfer, and it was almost as doubtful under the cases whether he made a 'transfer' by designating his wife as the survivor annuitant under the contract or plan. The Internal Revenue Service attacked primarily contracts under which the employee could choose between (a) an annuity for his life alone and (b) an annuity at a reduced rate for his life with payments to continue to his wife after his death. If the employee elected to take the reduced annuity, the Service asserted that he had transferred property within the meaning of Section 811(c) of the 1939 Code. The courts in general rejected this position. Commissioner v. Twogood's Estate, 194 F.2d 627 (2d Cir. 1952); Higgs' Estate v. Commissioner 184 F.2d 427 (3d Cir. 1950); Note, 64 Harv. L. Rev. 674 (1951). The Internal Revenue Service, however, persisted in its view that the rights of the survivor were includible in the employee's gross estate, at least where he made an election of the kind just described. Rev. Rul. 158, 1953-2 C.B. 259; Rev. Rul. 260, ibid. 262." — ED.

tions he designated), in 60 equal monthly installments. These payments were to be made only if a wife or minor child survived the officer and would continue only so long as there was a surviving wife or child under 21. However, if prior to retirement the officer became totally incapacitated, mentally or physically, for further performance of duty, the payments would be made to him in 60 equal monthly installments so long as he survived, any unpaid installment going to his widow or minor children. The president of the company was to notify each officer covered by the Plan of the benefits payable to him and was also "to represent that the Plan is irrevocable, not subject to later withdrawal by this Board [of Directors], and represents a firm commitment on the part of the Company to extend benefits in accordance with the terms and conditions herein set forth" (finding 6). Mr. Bahen was immediately notified of this Deferred Compensation Plan and its irrevocability.

Both of these plans were established by the voluntary unilateral action of the C. & O. The costs were not deducted from other compensation received by Mr. Bahen. Both plans were unfunded and the company did not purchase insurance policies or annuity contracts in connection with them. . . .

Mrs. Bahen received $7,437.50 (three months' salary) under the Death Benefit Plan and 60 monthly payments totaling $100,000 under the Deferred Compensation Plan. These amounts were not included in the estate tax return on Mr. Bahen's estate. On audit, the Commissioner of Internal Revenue made an additional assessment on the basis of his determination that the value at the decedent's death of the benefits payable under the two plans was includable in the gross estate. This additional assessment was paid, and a claim for refund was filed on July 28, 1959, and rejected on November 10, 1959.

The Government invokes each of four sections [§2036(a), §2037, §2038(a)(1), and §2039] as authority for the inclusion in Mr. Bahen's taxable estate of the value of his employer's payments to Mrs. Bahen under the two plans. We need consider only Section 2039, a new provision added to the estate tax in 1954 which for the first time established specific rules for the coverage of annuities and other survivor benefits. . . .

Section 2039 was a development of the earlier provisions of the estate tax which spoke of the decedent's "property" and of "transfers" by the decedent in contemplation of or taking effect at death. See Section 811 of the Internal Revenue Code of 1939. The new section does not use that phraseology but frames its operative requirements more directly in terms of particular types of transactions or arrangements involving the decedent. This change is significant. We must pay heed to the precise new form in which Congress cast its net and not become entangled in the older meshes.

A. *The Deferred Compensation Plan:* We first consider the application of Section 2039 (and the Regulations) to the C. & O.'s major plan, the Deferred Compensation Plan (of 1953) under which $100,000 was paid to Mrs. Bahen in a five-year span. As we read the section and the Regulations, they demand inclusion in the estate of the proceeds of this Plan. Every requirement is squarely met, not only in literal terms but in harmony with the legislative aim.

1. There is, initially, no doubt that the Plan, though adopted by the company unilaterally and without negotiation with the officers and employees, was a "form of contract or agreement" under the statute. This phrase is defined by Section 20.2039-1(b)(1)(ii) of the Treasury Regulations on Estate Tax to include "any arrangement, understanding or plan, or any combination of arrangements, understandings, or plans arising by reason of the decedent's employment." A compensation plan unilaterally adopted by the employer, but made irrevocable and communicated to the employee, falls directly within this definition, at least where the

employee continues in the company's service after the adoption of the plan.

2. There is likewise no doubt that Mrs. Bahen, the beneficiary, received "an annuity or other payment" under the statute when she was paid the $100,000 in sixty equal installments. The Regulations (Sec. 20.2039-1(b)(1)(ii)) appropriately say that this double term in Section 2039, as used with respect to both the beneficiary and the decedent, "has reference to one or more payments extending over any period of time," and that the payments may "be equal or unequal, conditional or unconditional, periodic or sporadic." See also S. Rept. No. 1622, 83d Cong., 2d Sess., at p. 470; H. Rept. No. 1337, 83d Cong., 2d Sess., at p. A315.

3. The next problem is whether at Mr. Bahen's death there was payable to him or he possessed the right to receive *"an annuity or other payment."* The Deferred Compensation Plan provided that, if Mr. Bahen became totally incapacitated for further performance of duty before retirement, the C. & O. would pay him the $100,000 in 60 equal monthly installments. Under both the normal understanding of the statutory words "annuity or other payment" and the broad definition given them by the Regulations (referred to above), these sums must be characterized as at least an "other payment." Stressing Congress's use of the singular "payment") and a reference in the Senate Committee report to a lump-sum payment in lieu of an annuity, plaintiff appears to urge that the *only* "payment" to a decedent covered by Section 2039 is a lump sum paid or payable in the place of a strict lifetime annuity (i.e., an annuity paid in the form of a lump sum). But we cannot confine the general language of Section 2039, as interpreted by the Regulations, within the limits of one illustration given by the Committee as a reason for adding the all-inclusive words "other payment" to "annuity." [1] As we point out more in detail below, the history and pattern of Section 2039 fail to indicate that it deals only with true lifetime annuities (in installment form or in a commuted lump sum). The statute covers — as an "other payment," at least — disability compensation benefits of the type involved here.

4. Were these benefit payments — assuming, as we have just decided, that they constituted an "annuity or other payment" within Section 2039 — "payable to" Mr. Bahen at his death or did he "possess the right to receive such annuity or payment"? The Regulations (Sec. 20.2039-1(1)(ii)) establish that amounts are "payable" to a decedent "if, at the time of his death, the decedent was in fact receiving an annuity or other payments, whether or not he had an enforceable right to have payments continue." Since Mr. Bahen was not receiving disability benefits when he died, this term of the statute is not satisfied.

We hold, however, that at his death Mr. Bahen did "possess the right" to receive the disability payments in the future if certain conditions were fulfilled, and therefore that the alternative requirement of Section 2039 is met. The intentional juxtaposition in the statute of amounts "payable" and those the decedent "possessed the right to receive" indicates that the former relates to the present (i.e., at time of death) and the latter to the future. The Regulations make clear that, in circumstances like these, the decedent's interest in future benefits, even if contingent, is sufficient. Where the employer has offered a plan of this kind, the employee's compliance with his obligations to the company gives him "an enforceable right to receive payments in the future, whether or not, at the time of his death, he had a present right to receive payments." This provision

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[1] Since the Deferred Compensation Plan provided that, in case of Mr. Bahen's disability, the $100,000 would be paid to him in 60 equal installments, it may also be possible to consider it an "annuity" — leaving aside "other payment" — within the meaning of Section 2039. The Senate Committee said that for the purposes of the section "the term 'annuity' includes periodic payments for a specified period of time." S. Rept. No. 1622, 83d Cong., 2d Sess., p. 470 (and see example (5)); see also H. Rept. No. 1337, 83d Cong., 2d Sess., at p. A315 (example (5)).

of the Regulations both governs the Deferred Compensation Plan and faithfully reflects its essential characteristics. The arrangement may have been unilateral in inception but it was also irrevocable, and its irrevocability was deliberately communicated to the individuals covered. It thus became an integral article of Mr. Bahen's terms of employment by the C. & O. See S. Rept. No. 1622, 83d Cong., 2d Sess., at p. 471, quoted in paragraph 6, infra. There can be no doubt that he and the others relied upon the Plan, as they were expected to do. See Worthen v. United States, 192 F. Supp. 727, 734 (D. Mass.). The right they possessed may have been contingent but it was not at the whim of the employer. Neuffer v. Bakery and Confectionery Workers, D.C. Cir., 1962, 307 F.2d 671.

In answer, the plaintiff insists that the decedent cannot be considered to have "possessed the right to receive" these disability payments because they were contingent on his becoming totally disabled before retirement, and would never have been received had he lived healthily to retirement age. Only future payments which are sure to be paid if the decedent lives to a designated time are covered by Section 2039, plaintiff says. However, as we have pointed out, in specifically covering amounts not payable to the decedent at the time of his death but which he then had merely the "right to receive," the statute and the Regulations obviously cover sums becoming due in the future; and there is no support in the statute's language for the distinction plaintiff makes between the different types of such future payments (at least if they are not forfeitable at the will of another). Both classes of payment are contingent and neither is sure. A benefit payable only if a man lives to a certain age is conditioned upon his living that long, just as a benefit payable only if he becomes disabled is conditional on his future disability.[2] Any distinction between the types seems rejected by the Regulations which include "conditional" payments without qualification. Moreover, the comparable term "right to income" in related earlier provisions of the estate tax (such as present §2036 . . .) has been in effect read as including a contingent right to receive income. See, e.g., Marks v. Higgins, 213 F.2d 884 (C.A. 2); . . . The legislative history of Section 2039 suggests that the rules applicable under Section 2036, in this connection, should likewise control under the new provision. S. Rept. No. 1622, 83d Cong., 2d Sess., at p. 472; H. Rept. No. 1337, 83d Cong., 2d Sess., at p. A316; see Stephens and Marr, Federal Estate and Gift Taxes (1959), pp. 108-109.

5. Another requirement of Section 2039 is that the decedent's right to receive payments must be possessed "for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death." For the period from February 1953, when the Deferred Compensation Plan was adopted, to his death in November 1955, Mr. Bahen had the right to receive, under this Plan, $100,000 in 60 installments upon his total disability prior to retirement. He thus possessed the right to receive this "annuity or other payment" for a period which did not in fact end before his death — and, accordingly, this element of Section 2039 is also present. The correctness of this conclusion is shown by the Regulations (Sec. 20.2039-1(b)(2)), Example (5) of which concerns a plan under which an employer-contributed fund is to be divided, on retirement at age 60, one-half in a lump sum to the employee and one-half to his beneficiary, the entire amount going to the beneficiary if the employee died

[2] In the light of the wording, background, and purpose of Section 2039, it would be far too narrow a construction to limit the "right to receive" element to those few future payments which the decedent was *certain* to receive, i.e., amounts which would inevitably come to him or (if he were dead) to his heirs. In any event, the Regulations do not so confine the section and we cannot say that the statute is so unambiguously to the contrary that the Regulations are unreasonable or invalid.

before retiring. The Regulations state that if the employee dies before retirement the payment to the beneficiary is includable in gross estate under Section 2039 because "the decedent possessed the right to receive a lump sum payment [at retirement] for a period which did not in fact end before his death [before retirement]." This regulation is consistent with the holdings, under older provisions of the estate tax, relating to the meaning of the phrase "for any period which does not in fact end before his death" . . . Marks v. Higgins, supra, . . . — rulings which Congress has indicated should be applied under Section 2039. S. Rept. No. 1622, 83d Cong., 2d Sess., at p. 472; H. Rept. No. 1337, 83d Cong., 2d Sess., at p. A316.

6. The last element necessary for coverage by Section 2039 is that Mr. Bahen must have "contributed" the "purchase price" of the "annuity or other payment" received by Mrs. Bahen which is to be included in the taxable estate. Subsection (b), which adds this requirement, provides:

> (b) *Amount includible.* — Subsection (a) shall apply to only such part of the value of the annuity or other payment receivable under such contract or agreement as is proportionate to that part of the purchase price therefor contributed by the decedent. For purposes of this section, any contribution by the decedent's employer or former employer to the purchased price of such contract or agreement (whether or not to an employee's trust or fund forming part of a pension, annuity, retirement, bonus or profit sharing plan) shall be considered to be contributed by the decedent if made by reason of his employment.

The second sentence of this subsection automatically attributes the employer's contribution to the employee "if made by reason of his employment." This phrase is given broad scope by the Senate Committee Report (S. Rept. No. 1622, 83d Cong., 2d Sess., at p. 471) which holds that it applies "if, for example, the annuity or other payment is offered by the employer as an inducement to employment, or a continuance thereof, or if the contributions are made by the employer in lieu of additional compensation or other rights, if so understood by employer and employee whether or not expressly stated in the contract of employment or otherwise." The Deferred Compensation Plan, we have already noted, plainly meets this standard; it was an inducement to continued service with the C. & O. It is immaterial, we think, that the company did not formally make "contributions" to a separate fund, or actually purchase annuity or like contracts. Section 2039(b) does not use the words "contribution," "contributed," or "purchase price" in a narrow literal sense, any more than subsection (a) uses "contract or agreement" in that rigid fashion. The section deals, for the area it covers, with the substance of transactions, not with the mechanical way they happen to be formulated. The C. & O.'s undertaking to make payment under the Plan was its "contribution," made by reason of the decedent's employment. Congress did not demand that the company create a tangible fund as a condition to coverage of its employees under this new estate tax provision, and so far as we can see there would be no reason to impose that requirement in a taxing statute such as this.

7. To all of this the plaintiff — in addition to challenging the existence in this case of some individual elements of coverage — protests that despite its literal language Section 2039 is applicable only where there is a true lifetime annuity payable to the decedent for life. Plaintiff correctly points out that the main impetus for the new section was the doubt in 1954 that the former estate tax provisions covered conventional joint and survivor annuities purchased wholly or partly *by the decedent's employer* (as distinguished from those purchased by the decedent himself). S. Rept. No. 1622, 83d Cong., 2d Sess., at p. 123; H. Rept. No. 1337, 83d Cong., 2d Sess., at p. 90. But the committee reports do not indicate that Congress, although using language in Section 2039 which goes well beyond

the precise situation which initially impelled the change, restricted the scope of the new provision to those very circumstances alone. We find nothing to show that Congress desired the broader words it carefully used in Section 2039 not to have their normal significance and application; indeed some of the examples and words Congress used in the Committee Reports (see the references, supra) show that wider coverage was plainly intended. And the Treasury Regulations, as our prior discussion explains, cover annuities and payments to a decedent other than a full lifetime annuity.

8. Finally, we note briefly that Section 2039, as we construe it, is harmonious with the general objective of the federal estate tax to include in the decedent's estate (with designated exceptions) the valuable interests belonging to, accumulated by, or created by or for him, which pass to others at his death. Many such benefits promised, given, and paid for by an employer were specifically brought within this framework by the new section in 1954. In subsection (b), quoted above, Congress provides that contributions by the employer "shall be considered to be contributed by the decedent if made by reason of his employment." Phrased in terms of the earlier concepts of a decedent's "property" "transferred" at his death, Section 2039 declares that annuities or other payments payable by an employer to his employee, and on his death to a beneficiary, constitute his property — created by him through his employer as part of the employment arrangement and in consideration of his continued services — which is transferred to another at his death. See the discussion in Lehman v. Commissioner, 109 F.2d 99, 100 (C.A. 2); and Worthen v. United States, 192 F. Supp. 727, 733-4 (D. Mass.). A new provision of the estate tax which attempts to apply these fundamental concepts to a fairly well understood set of concrete situations should not be grudgingly read so as to chip away at the specific rule and to continue (as in the past) to leave as much as possible to the ambiguities of the general sections.

Plaintiff does not attack the validity of Section 2039, interpreted as we read it, and any challenge would be baseless under the accepted principles marking the outer boundaries of the constitutional power of Congress to levy the estate tax. See, e.g., United States v. Manufacturers National Bank [infra p. 1246]; Fernandez v. Wiener [supra p. 1106]; . . .

B. *The Death Benefit Plan:* It is a more difficult question whether the Death Benefit Plan — under which the C. & O. paid Mrs. Bahen a sum equal to Mr. Bahen's salary for three months — is covered by Section 2039. Under that arrangement no benefits were payable to the decedent during his life, and if the Plan were to be judged by itself it would fall outside the ambit of the section for lack of "an annuity or other payment" to the decedent. The defendant contends that this factor is present because the words "or other payment" can include the decedent-employee's regular salary; the Death Benefit Plan must be taken, defendant says, together with Mr. Bahen's entire employment arrangement including his ordinary compensation. We cannot agree. Since employees normally receive salary or wages, defendant's interpretation would effectively obliterate, for almost all employees, the express requirement in Section 2039 of "an annuity or other payment" to the decedent. If Congress had intended that strange result, it would certainly have mentioned or referred to it.[3] The Government's argument also

[3] The Government points to Example (4) in the Senate Report (S. Rept. No. 1622, 83d Cong., 2d Sess. at p. 470) — which on the surface omits any "annuity or other payment" to the decedent and therefore, according to the Government, must incorporate the employee's salary as satisfying that element — but we agree that this interpretation of the example cannot be correct. See Bittker, Estate and Gift Taxation under the 1954 Code: The Principal Changes, 29 Tul. L. Rev. 453, 469-470, fn. 58 (1955); Pincus, Estate Taxation of Annuities and Other Payments, 44 Va. L. Rev. 857, 866-867 (1958).

runs counter to the theory and examples of the Regulations (Sec. 20.2039-1) which impliedly exclude ordinary salary from consideration.

But the Government makes another point which we do accept as bringing the Death Benefit Plan under Section 2039. The suggestion is that this Plan should not be viewed in isolation but must be considered together with the Deferred Compensation Plan — as if both arrangements were combined into one plan, providing two types of benefits for beneficiaries after the employee's death but only one type of benefit (disability compensation) to the employee himself. There is some factual support, if that be necessary, for looking at the two plans together, since the Death Benefit Plan was adopted in January 1952 and the Deferred Compensation Plan only a year later in February 1953. There appears to be a common genesis and a unifying thread.

The firmer legal basis is provided by the Regulations (Sec. 20.2039-1(b)(2), Example (6)) which provide: "All rights and benefits accruing to an employee and to others by reason of the employment (except rights and benefits accruing under certain plans meeting the requirements of section 401(a) (see §20.2039-2)) are considered together in determining whether or not section 2039(a) and (b) applies. The scope of Section 2039(a) and (b) cannot be limited by indirection." Effect must be given to this declaration, adopted pursuant to the Treasury's recognized power to issue regulations and not challenged by plaintiff, since it does not violate the terms or the spirit of Section 2039. In view of the general purpose of the statute to cover a large share of employer-contributed payments to an employee's survivors, it is not unreasonable to lump together all of the employer's various benefit plans taking account of the employee's death (except those qualified under Section 401(a), which are excepted by [§2039(c)]) in order to decide whether and to what extent Section 2039 applies to his estate. There is no immutable requirement in the legislation that each plan separately adopted by a company must be considered alone. One good ground for rejecting that position is to prevent attempts to avoid the reach of the statute by a series of contrived plans none of which, in itself, would fall under the section.[4]

This directive in the Regulations that all rights and benefits "are to be considered together" — read with another part of the same Regulation which defines "contract or agreement" under Section 2039 to cover "any combination of arrangements, understandings, or plans arising by reason of the decedent's employment" — requires the two plans of the C. & O. to be deemed a coordinated whole for the purposes of Section 2039. On that view the payments under the Death Benefit Plan were includable in the decedent's gross estate for the reasons given above with respect to the Deferred Compensation Plan. If the two Plans are integrated into one, each element required for coverage of all payments is present.

We conclude that the plaintiff is not entitled to a refund of the estate taxes assessed because of the inclusion by the Commissioner of Internal Revenue in the decedent's estate of the value of the benefits paid by the C. & O. to his widow under the two plans. Judgment will be entered for the defendant and the petition will be dismissed.

It is so ordered.

JONES, Chief Judge, and DURFEE, and LARAMORE, Judges, concur.

WHITAKER, Judge (concurring).

This case presents what is to me a novel problem. The Deferred Compensation Plan of the C. & O. Railway was adopted solely on its own initiative; it was

[4] There is no suggestion that the two plans in this case, which were adopted in 1952 and 1953 before Section 2039 was enacted, formed part of any such scheme. But the statute and the Regulation can establish a prophylactic across-the-board rule applicable to all cases, regardless of the purity of motivation in a particular instance.

not the result of bargaining between the railroad and its officers. At the death of the employee the railroad paid to the employee's beneficiaries the amount it had voluntarily agreed to pay. Hence, it has been difficult for me to discern any transfer from the decedent to the beneficiaries. If there was no transfer from him to them, the amount they received under the Plan could not constitutionally be included in his gross estate for estate tax purposes.

The Constitution, art. 1, §9, cl. 4 provides that "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census . . ." This prohibits the levy of a direct tax on this property. Only the states can levy such a tax.

I suppose this constitutional prohibition has so far survived the innovations of modern constitutional "interpretation." If it has, the Federal Government has no power to tax property passing at death unless it can be justified as an excise tax. It was so justified by the Supreme Court in Knowlton v. Moore, 178 U.S. 41, as a tax on the privilege of transmitting property at death to the survivors of the decedent. The rationale of that decision is well known and I shall not elaborate on it in this opinion.

It follows from this, it seems to me, that, if the decedent did not transfer this property at death, it cannot be included in his gross estate for estate tax purposes. The question then is, did the decedent transfer it?

Although the Plan was initiated by the railroad and was wholly of its own volition, nevertheless, the Plan did contain this provision:

> In any case, an officer leaving the service of the Company for any reason other than death, incapacity as hereinbefore defined, or retirement, shall forfeit all benefits under the Deferred Compensation Plan.

Under this I suppose it is not unreasonable to say that, by the act of continuing in the employ of the railroad, the employee made it possible for his beneficiaries to receive what the railroad agreed to pay them. They were entitled to benefits under the Plan only if the employee remained with the railroad until death or until he was eligible for retirement. Therefore, by remaining with the company, he fulfilled that condition without which the beneficiaries would have been entitled to nothing. So it can be said, and properly so, I suppose, that the decedent "had a hand" in the transmission of the property to the beneficiaries, and, hence, Congress intended it to be included in his gross estate.

I concur.

NOTE

1. *Voluntary payments and §2039.* The employer was contractually obligated to make the payments in *Bahen's Estate.* In Barr's Estate v. Commissioner, supra page 1082, the government cited §2039 (as well as §2033) as authority for including the benefits paid to the employee's widow in his gross estate, but the §2039 claim was rejected for want of a contract or agreement:

> The repeated reference [in §2039(a) and (b)] to the requirement for some form of contract or agreement, indicates that the rights of both the decedent and the survivor must be enforceable rights; and that voluntary and gratuitous payments by the employer are not taxable under section 2039. This is expressly recognized in Example (4) of [Regs. §20.2039-1(b)]. However, this same example does state that where the terms of an enforceable retirement plan have been modified by consistent practice of the employ, the annuity received pursuant to such modification will be considered to have been paid under a "contract or agreement." We do not think that the latter statement was intended to mean that where there was no enforceable arrangement, contract or agreement whatever, the mere consistency of an employer in making voluntary or gratuitous payments would be sufficient to supply the essential "contract

or agreement." Congress, for reasons satisfactory to it, has made the existence of some form of "contract or agreement" an indispensable prerequisite to the application of section 2039.

In the instant case, as we have hereinbefore found, there was no express contract entered into between decedent and Eastman, under which his widow would be entitled to receive any wage dividend that the board of directors might declare subsequent to his death. And the creation of any contract by implication is negatived, not only by the fact that Eastman did not pay a wage dividend death benefit to the survivors in every case; but also by the fact that its rules for participation made it clear that employees who died before the end of the Kodak year would receive benefits only at the company's option — as distinguished from employees who survived until after close of the Kodak year, and thereby became entitled to have the wage dividend paid to their estates or survivors "as a matter of right." [40 T.C. at 170.]

2. *Life insurance unaffected by §2039.* Section 2039 does not embrace amounts payable "as insurance under policies on the life of the decedent." In All v. McCobb, 321 F.2d 633 (2d Cir. 1963), a determination by the District Court that a payment by Standard Oil Company (New Jersey) under its "death benefit plan" constituted life insurance was reversed:

> The statute thus clearly calls for inclusion in the decedent's gross estate of the death benefits paid to the widow, unless these benefits can be found to have been insurance, as the district court found. It based this finding upon the ground that "the payments in this case were designed to provide partial protection for one year to her as a dependent beneficiary against loss of retirement allowances to her husband through his untimely death." 206 F. Supp. at 903. We hold that this finding is without support and cannot be sustained. The fact that a payment is designed to afford a widow partial protection against the difficulties presented by her husband's death does not, ipso facto, convert that payment into insurance. The function of providing partial protection to widows is characteristic of a great many survivorship annuities and payments which nevertheless are not insurance for purposes of federal estate taxation and which are includable within a decedent's gross estate and taxable as such under §2039. See Comment, 66 Yale L.J. 1217, 1238-48 (1957). It is thus necessary to carry the analysis beyond the point of merely concluding that the payments to the widow provided her with partial protection after the death of her husband, because that conclusion cannot logically be dispositive. [321 F.2d at 636.]

The court then quoted from the definitions of "life insurance" in the *LeGierse* and *Treganowan* cases, infra pages 1255 and 1257, and concluded:

> Judged by the standards of *LeGierse* and *Treganowan*, the Death Benefit Plan bears no resemblance to a life insurance program. The Plan was unfunded and the company did not make periodic contributions to it in the employee's name. "Premium payments [were] not required, nor [was] there a shifting and spreading of the risk of death in any meaningful sense." Essenfeld v. Commissioner, 311 F.2d 208, 209 (2 Cir., 1962). The decedent in no way shifted to the company the risk that his death would come prematurely and before the company, as insurer, had received premiums by or on his account in a sum equal to the amount required to be paid to the beneficiary. The company in no way gambled with the decedent that he would live a long life and that it would recover by periodic assessments before his death the amount to be paid to the beneficiary. It made no difference to the company, so far as any fund was concerned, whether the decedent died prematurely or not. Cf. Old Colony Trust Co. v. Commissioner, 102 F.2d 380 (1st Cir., 1939). Nor did the company in any way undertake to distribute among a larger group of employees, on the basis of actuarial data from which the appropriate size of a terminal reserve could be computed, the risk of the premature death of a single employee. The company did nothing more than promise to pay a sum certain to a named beneficiary upon the death of a retired employee. If payments resulting from such a promise were under the present facts to be regarded as insurance, the effectiveness and significance of §2039 would be greatly diminished, if not vitiated.

Even if the Death Benefit Plan were to be considered together with the Annuity Plan as a "coordinated system of payments to employees in consideration for their services," Essenfeld v. Commissioner, 311 F.2d at 209, the result would remain the same. The Treasury Regulations provide that "A combination annuity contract and life insurance policy on the decedent's life (e.g., a 'retirement income' policy with death benefits) which matured during the decedent's lifetime so that there was no longer an insurance element under the contract at the time of the decedent's death is subject to the provisions of §2039(a) and (b)." Treas. Reg. §20.2039-1(d). [321 F.2d at 637.]

3. *Payments under "qualified pension plans."* Section 2039(c) provides that the value of an annuity receivable under a qualified pension or similar plan is excludable from the gross estate, unless it is receivable by the executor or attributable to payments or contributions by the decedent. The reason for granting this exclusion is not apparent; if the survivor's rights were analogized to rights under a life insurance policy, it is surprising that there is no requirement that the decedent give up the incidents of ownership in the contract (see p. 1247 infra). Since §2039(c) provides for an exclusion "notwithstanding the provisions of this section or of any provision of law," a right in the decedent to change the beneficiary or to surrender the contract for cash will not be fatal as it would be in the case of life insurance. Moreover, there will ordinarily be no gift tax on the creation of the survivor's rights, by virtue of §2517, enacted in 1962. If the estate tax exclusion was granted on the assumption that benefits under qualified plans are ordinarily minor in amount, it should be noted that that exclusion is needed only if the estate exceeds $60,000 in amount or, in the case of a married decedent who takes full advantage of the marital deduction, $120,000. The rights of the survivor under a qualified plan now constitute a unique class of property that escapes the estate tax despite the retention by the decedent of complete control over the rights of the beneficiary.

4. *References.* Kramer, Employee Benefits and Federal Estate and Gift Taxes, 1959 Duke L.J. 341; Pincus, Estate Taxation of Annuities and Other Payments, 44 Va. L. Rev. 857 (1958); Zissman, Problem Areas in the Estate Tax, 41 Taxes 875, 884-890 (1963); Murphy, The Survivorship Annuity: Estate Tax Kaleidoscope, 1 How. L.J. 1 (1955); Meisenholder, Taxation of Annuity Contracts Under Estate and Inheritance Taxes, 39 Mich. L. Rev. 856 (1941) (antedates §2039, but still useful).

CHAPTER 14

Life Insurance and Powers of Appointment

SECTION A. LIFE INSURANCE

1. *Policies on the Life of the Decedent: §2042**

Pre-1942 treatment of insurance on the decedent's life. The Revenue Act of 1916 made no mention of life insurance, with the consequence that proceeds of insurance policies on the life of the decedent were included in his gross estate only when the predecessor of §2033 was applicable. This meant that policies payable to the decedent's estate were taxable, but not policies payable to designated beneficiaries. In the Revenue Act of 1918, however, Congress included a provision — the forerunner of §2042 — dealing specifically with insurance on the life of the decedent. Although the principal purpose of the 1918 legislation was to reach policies payable to designated beneficiaries, it also provided that insurance proceeds "receivable by the executor" were includible in the gross estate. The latter provision has been carried forward to the present, and it now appears as §2042(1). It reaches insurance proceeds that are available for payment of the decedent's debts even though not in form payable to the executor. Matthews' Estate v. Commissioner, 3 T.C. 525 (1944). Conversely, proceeds payable in form to the executor may escape §2042(1) if local law immunizes them from liability for the decedent's debts so that the executor holds them for the benefit of others. Flick's Estate v. Commissioner, 166 F.2d 733 (5th Cir. 1948); United States v. First National Bank & Trust Co. of Minneapolis, 133 F.2d 886 (8th Cir. 1943).

The more troublesome part of the 1918 legislation dealt with policies payable not to the executor but to other beneficiaries. It provided for the inclusion of amounts "receivable by all other beneficiaries as insurance under policies taken out by the decedent upon his own life," except that the first $40,000 of such proceeds was exempt. The innocent phrase "policies taken out by the decedent" was productive of nothing but trouble. If the 1918 legislation was to be of any consequence, it could not be limited to policies actually applied for by the decedent. Whether the decedent signed the formal application or not, the policy would serve as a device for transmitting wealth from one generation to another if the decedent paid the premiums. Moreover, even if the decedent neither applied for the policy nor paid the premiums, he could effect the transmission of wealth if he held until his death the power to name or change the beneficiary, to assign or pledge the policy, or to surrender it for its cash value. Was a policy "taken out by the decedent" if he paid the premiums or if he possessed the "incidents of ownership"? Were both necessary? During the long period that the statute included the phrase "taken out by the decedent," regulation succeeded regulation as the Treasury Department turned from one construction to another like a whirling dervish. Its dizzy antics, which were in part an effort to propitiate the courts, are described in Eisenstein, Estate Taxes and the Higher Learn-

* Section 2042 applies only to policies of insurance on the life of the decedent himself. For the treatment of policies on the life of another person, which were owned or paid for by the decedent, see page 1258 infra.

ing of the Supreme Court, 3 Tax L. Rev. 395, 513-536 (1948); Schlesinger, Taxes and Insurance: A Suggested Solution to the Uncertain Cost of Dying, 55 Harv. L. Rev. 226 (1941); Paul, Life Insurance and the Federal Estate Tax, 52 id. 1037 (1939).

1942-1954: The "premiums paid" and "incidents of ownership" tests. Congress finally intervened. The Revenue Act of 1942 wiped out the $40,000 exemption for policies payable to beneficiaries (simultaneously increasing the over-all estate tax exemption from $40,000 to $60,000) and eliminated the troublesome words "taken out by the decedent." It went on to provide that insurance proceeds payable to designated beneficiaries were includible in the decedent's gross estate if he *either* (1) had paid the premiums directly or indirectly, *or* (2) possessed at the time of his death any of the "incidents of ownership" exercisable either alone or in conjunction with any other person.

Because the "premiums paid" test required the insurance proceeds to be included in the insured's gross estate even though he retained no control over the policy, its constitutionality was attacked on the ground that it was a "direct tax" on the property, invalid because not apportioned among the states in proportion to population. This theory was rejected by the Supreme Court in United States v. Manufacturers National Bank, 363 U.S. 194, 198-199 (1960):

From its inception, the estate tax has been a tax on a class of events which Congress has chosen to label, in the provision which actually imposes the tax, "the *transfer* of the net estate of every decedent." See New York Trust Co. v. Eisner, 256 U.S. 345. If there is any taxable event here which can fairly be said to be a "transfer" . . . , the tax is clearly constitutional without apportionment. For such a tax has always "been treated as a duty of excise, because of the particular occasion which gives rise to its levy." Knowlton v. Moore, 178 U.S. 41, 81; New York Trust Co. v. Eisner, supra, at 349.

Under the statute, the occasion for the tax is the maturing of the beneficiaries' right to the proceeds upon the death of the insured. Of course, if the insured possessed no policy rights, there is no transfer of any interest *from him* at the moment of death. But that fact is not material, for the taxable "transfer," the maturing of the beneficiaries' right to the proceeds, is the crucial last step in what Congress can reasonably treat as a testamentary disposition by the insured in favor of the beneficiaries. That disposition, which began with the payment of premiums by the insured, is completed by his death. His death creates a genuine enlargement of the beneficiaries' rights. It is the "generating source" of the full value of the proceeds. See Schwarz v. United States, 170 F. Supp. 2, 6. The maturing of the right to proceeds is therefore an appropriate occasion for taxing the transaction to the estate of the insured. Cf. Tyler v. United States, 281 U.S. 497, 503, 504.

There is no inconsistency between such a view of the taxable event and the basic definition of the subject of the tax in [§2001]. "Obviously, the word 'transfer' in the statute, or the privilege which may constitutionally be taxed, cannot be taken in such a restricted sense as to refer only to the passing of particular items of property directly from the decedent to the transferee. It must . . . at least include the transfer of property procured through expenditures by the decedent with the purpose, effected at his death, of having it pass to another." Chase National Bank v. United States, 278 U.S. 327, 337.

It makes no difference that the payment of premiums occurred during the lifetime of the insured and indirectly effected an inter vivos transfer of property to the owner of the policy rights. Congress can properly impose excise taxes on wholly inter vivos gifts. Bromley v. McCaughn, 280 U.S. 124. It may impose an estate tax on inter vivos transfers looking toward death. Milliken v. United States, 283 U.S. 15. Surely, then it may impose such a tax on the final step — the maturing of the right to proceeds — in a partly inter vivos transaction completed by death. The question is not whether there has been, in the strict sense of the word, a "transfer" of property owned by the decedent at the time of his death, but whether "the death has brought into being or ripened for the

survivor, property rights of such character as to make appropriate the imposition of a tax upon that result. . . ." Tyler v. United States, supra, at 503.

The Court also rejected an attack on the constitutionality of the 1942 provision, based on the fact that some of the premiums were paid before 1942; the change of law did not offend the due process clause of the Fifth Amendment because it was not "a wholly arbitrary thing."

The "premiums paid" test of the 1942 law applied to premiums paid "indirectly" by the insured, as well as to those paid directly. For some of the "tracing" problems that arose because of this aspect of the provision, see Loeb's Estate v. Commissioner, 29 T.C. 22 (1957); see also Carlton's Estate v. Commissioner, 298 F.2d 415 (2d Cir. 1962) (premiums treated as paid by grantor of funded insurance trust); supra page 1114 (re payment of consideration for jointly held property).

The alternative basis for including life insurance proceeds in the insured's gross estate under the 1942 law was his retention of any of the "incidents of ownership." This term was defined by the Regulations as follows:

> Incidents of ownership in the policy include, for example, the right of the insured or his estate to its economic benefits, the power to change the beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge it for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. [Regs. 105 §81.27(c).]

The 1942 law did provide, however, that a reversionary interest was not an "incident of ownership." But if the decedent possessed a reversionary interest (e.g., if the proceeds would be payable to his estate should the beneficiary predecease him), the proceeds might have been reached by the postponed-possession-or-enjoyment clause of old §811(c).

The 1954 Code: elimination of "premiums paid" test. The 1954 Code made two changes in this pattern of taxing proceeds payable to named beneficiaries. It eliminated the premiums paid test; and it provided that a reversionary interest is an "incident of ownership" if its value exceeded 5 per cent of the value of the policy immediately before the death of the decedent.

The elimination of the premiums paid test was perhaps the 1954 Code's most important innovation in the estate tax law. The Senate Report stated (p. 124):

> No other property is subject to estate tax where the decedent initially purchased it and then long before his death gave away all rights to the property and to discriminate against life insurance in this regard is not justified.

Opposing the change, a minority of the House Ways and Means Committee said:

> Under present law, if a husband transfers ownership of an insurance policy on his life to his wife, but continues to pay the premiums himself, the proceeds are still considered to be a part of the estate he leaves his wife on his death and are, therefore, included in his estate in computing the estate tax.
>
> It is sought to justify the change as merely putting life insurance on a par with other property which may be given away free from estate tax if the gift is not made "in contemplation of death." But life insurance is not like other property. It is inherently testamentary in nature. It is designed, in effect, to serve as a will, regardless of its investment features. Where the insured has paid the premiums on life insurance for the purpose of adding to what he leaves behind at his death for his beneficiaries, the insurance proceeds should certainly be included in his taxable estate.
>
> We predict that if this provision becomes law, it will virtually do away with the estate taxation of life insurance. To avoid the tax, the insured need only assign the policy to his wife or other beneficiary. Since estates of less than $60,000 are nontaxable, only the wealthy will benefit. Nevertheless, we predict that the estate-tax revenue loss will be sub-

stantial. Doubtless life insurance will come into great favor among persons of wealth as a means of avoiding estate taxes.

The proposal goes even further than the method of taxing life-insurance proceeds as a part of estates that prevailed prior to 1942, when an exclusion of $40,000 was provided, which Congress eliminated in the Revenue Act of 1942. [H.R. Rept. No. 1337, 83d Cong., 2d Sess., B14-15.]

From 1942 to 1954, the incidents of ownership test was not of great importance, since in most cases the head of the family could not avoid paying the premiums on his insurance directly or indirectly, and consequently the proceeds would be includible under the premiums paid test. Under the 1954 Code, however, the insured can pay the premiums himself and at the same time keep the proceeds out of his estate by ridding himself of the incidents of ownership. The right to change beneficiaries, to surrender the policy for cash, to pledge it for a loan, to assign it, can be given up easily enough, if the insured wishes to do so. A reversionary interest can be avoided by providing that the proceeds are to be paid to a designated beneficiary or, if he predeceases the insured, to the beneficiary's estate. Moreover, the Regulations provide, in §20.2042-1(c)(3), that the terms "reversionary interest" and "incidents of ownership" do not include the possibility that the insured might receive a policy or its proceeds by inheritance or as a surviving spouse by election. See Mannheimer, Wheeler and Friedman, Gifts of Life Insurance by the Insured, 13 N.Y.U. Inst. on Fed. Taxation (1955) 247, 251 (1955); reprinted in 33 Taxes 299, 301 (1955).

The Senate Report states (p. 473):

In determining whether [a reversionary interest] exceeded 5 percent, this section [§2042] provides rules substantially the same as prescribed in section 2037 for determining whether, in the case of certain transfers, the decedent retained a reversionary interest in the transferred property.

In applying the 5 per cent rule, how is "the value of the policy immediately before the death of the decedent" to be determined? Is it the cash surrender value? See Guggenheim v. Rasquin, infra. If the decedent "immediately" before his death was suffering from a protracted illness, or was in an automobile that had just gone over a cliff, is the "value" of the policy its full face amount?

Gift tax on transfers of insurance contracts and payments of premiums. The repeal of the premiums paid test in 1942 brought in its train many transfers of policies that had been in force for some time. The transfer of such a policy is a "gift" under §2511(a), and a gift tax may be due. How is the policy to be valued? In Guggenheim v. Rasquin, 312 U.S. 254 (1941), a donor made a gift of three single-premium life insurance policies (with an aggregate face amount of $1,000,000) immediately after purchasing them. Although she had paid about $852,000 in premiums, the cash surrender value of the policies was only about $717,000, and she valued them at the lower amount on her gift tax return. The Supreme Court held that the proper value was her cost:

Cash-surrender value is the reserve less a surrender charge. And in case of a single-premium policy the reserve is the face amount of the contract discounted at a specified rate of interest on the basis of the insured's expected life. If the policy is surrendered, the company will pay the cash-surrender value. It is asserted that the market for insurance contracts is usually the issuing companies or the banks who will lend money on them; that banks will not loan more than the cash-surrender value; and that if policies had an actual realizable value in excess of their cash-surrender value, there would arise a business of purchasing such policies from those who otherwise would surrender them. From these facts it is urged that cash-surrender value represents the amount which would be actually obtained for the policies in a willing buyer-willing seller market. . . .

That analysis, however, overlooks the nature of the property interest which is being valued. Surrender of a policy represents only one of the rights of the insured or beneficiary. Plainly that right is one of the substantial legal incidents of ownership. . . . But the owner of a fully paid life insurance policy has more than the mere right to surrender it; he has the right to retain it for its investment virtues and to receive the face amount of the policy upon the insured's death. That these latter rights are deemed by purchasers of insurance to have substantial value is clear from the difference between the cost of a single-premium policy and its immediate or early cash-surrender value — in the instant case over $135,000. All of the economic benefits of a policy must be taken into consideration in determining its value for gift-tax purposes. To single out one and to disregard the others is in effect to substitute a different property interest for the one which was the subject of the gift. In this situation as in others (Susquehanna Power Co. v. State Tax Comm'n, 283 U.S. 291, 296) an important element in the value of the property is the use to which it may be put. Certainly the petitioner here did not expend $852,438.50 to make an immediate gift limited to $717,344.81. Presumptively the value of these policies at the date of the gift was the amount which the insured had expended to acquire them. Cost is cogent evidence of value. And here it is the only suggested criterion which reflects the value to the owner of the entire bundle of rights in a single-premium policy — the right to retain it as well as the right to surrender it. Cost in this situation is not market price in the normal sense of the term. But the absence of market price is no barrier to valuation. [312 U.S. at 256-257.]

Although the Supreme Court held that the cost of the policy was the proper measure of its value in this case, the cash surrender value of a policy that has been in force for some time might exceed the aggregate premiums paid. Moreover, neither the cash surrender value nor the aggregate cost is a fair index of the value of the policy if the insured has become uninsurable. In United States v. Ryerson, 312 U.S. 260, 261-262 (1941), the Court said of a gift of such policies:

The cost of duplicating the policies at the dates of the gifts is, in absence of more cogent evidence, the one criterion which reflects both their insurance and investment value to the owner at that time. . . . The fact that the then condition of an insured's health might make him uninsurable emphasizes the conclusion that the use of that criterion will result in placing a minimum value upon such a gift.

See also Regs. §25.2512-6 (use of "terminal reserve" in computing value of life insurance contract); Goodman v. Commissioner, 156 F.2d 218 (2d Cir. 1946).

Is the transfer of a policy or the subsequent payment of premiums a gift of a present or of a future interest? Does this depend on whether the policy has a cash surrender value? On whether the donee could surrender it for cash without undue sacrifice of its other values? See Rev. Rul. 55-408, 1955-1 C.B. 113 (exclusion applies to unqualified assignment of insurance policy, despite absence of cash surrender value).

Transfers of insurance and payments of premiums as gifts in contemplation of death. The possibility that the transfer of an insurance policy or the payment of premiums will be taxed as a gift in contemplation of death, if the donor-insured dies within three years, must not be overlooked. If the insured makes the transfer to rid himself of the incidents of ownership so as to avoid estate tax, is the transfer ipso facto a gift in contemplation of death? Does the fact that a policy will take on added value at the donor's death mean that insurance is "inherently testamentary" so that a transfer of a policy or a payment of premiums is more likely to be a gift in contemplation of death than a transfer of other property? See Garrett's Estate v. Commissioner, 180 F.2d 955, 956-957 (2d Cir. 1950), involving a life insurance trust:

We have twice recently considered under what circumstances the transfer of policies upon a settlor's life should be taken as made in contemplation of death [First Trust &

Deposit Co. v. Shaughnessy, 134 F.2d 940; Vanderlip v. Commissioner, 155 F.2d 152]; and we have said that it did not inevitably follow, even though the beneficiaries cannot receive any part of the proceeds, living the settlor, that the gift was so made. The settlor may have wished to part with control over the policies for motives which were to be satisfied while he lived; for example, he may have wished to assure himself against any temptation to use them in his business; or he may have feared possible bankruptcy, or have wished to give the beneficiaries a present certainty on which they might build while he lived. Nevertheless, although for these reasons it would go too far to say that a transfer of policies can never be other than testamentary, when the beneficiary cannot possibly profit by them, living the settlor, ordinarily such a transfer will be of that kind. A conveyance of property which the grantee can by no chance use until the grantor's death, will so commonly be in the main testamentary, that it is fair to infer that that was its preponderating, if not indeed its only, purpose, unless there be affirmative evidence of other contributory motives.

Note the similarity of this reasoning to the same court's decision in the *Reeves' Estate* case, supra page 1136. *Garrett's Estate* involved insurance policies transferred in trust. Would the Court of Appeals for the Second Circuit apply the same reasoning to policies with cash surrender or loan values that are assigned directly to the beneficiaries, so that they can either cash or borrow against the policies immediately?

A different approach to life insurance is found in Flick's Estate v. Commissioner, 166 F.2d 733, 740 (5th Cir. 1948):

Even though it be true, as the Tax Court reasoned, that all life insurance reaches its greatest value at the death of the insured, nevertheless Congress has not undertaken to convert a valid, absolute, complete gift inter vivos into a gift causa mortis or a substitute for testamentary disposition merely because the gift will have a greater value after the death of the donor.

See also Hull's Estate v. Commissioner, 325 F.2d 367 (3d Cir. 1963), involving a transfer of life insurance contracts by the decedent to his recently divorced and emotionally insecure daughter, in which the court said that the transfer was not necessarily "testamentary" because it involved insurance contracts, "particularly in a case like this where full ownership rights were transferred unconditionally, and the policies had substantial cash value."

If premiums are paid by the decedent in contemplation of death, is the amount includible in his gross estate the amount paid, the resulting increase in the value of the policy, the face amount (if the policy would have lapsed for nonpayment of premiums), or some other amount? Unless the policy is fully paid up or the premiums are paid by someone other than the decedent, note that he will perforce have paid premiums during the three-year presumptive period of §2035(b).

Life insurance trusts. With the 1954 repeal of the premiums paid test, there has been a revival of interest in the life insurance trust, a device by which income-producing property is transferred to a trustee to pay premiums on insurance on the settlor's life. (The settlor either transfers his insurance policies at the same time or the trustee takes out new policies.) Upon the settlor's death, the beneficiaries receive both the insurance proceeds and the property whose income was previously used to keep up the policies. Before 1954, the insurance proceeds would be includible in the settlor's gross estate because he had paid the premiums indirectly, and the trust corpus would also have been includible, at least during the period when Reinecke v. Northern Trust Co. was no longer followed (1948-1954, supra p. 1217), because the beneficiaries' possession or enjoyment matured at the time of his death. Under the 1954 Code, §2042 would not reach the insurance proceeds and §2037 would not reach the corpus if the settlor had no incidents of ownership in the policy and no reversionary interest in the corpus. Would §2036 be applicable to the corpus? Note that the income of the trust would continue to

be taxed to the settlor under §677(a)(3), supra page 371; the 1954 repeal of the premiums paid test for the estate tax was not accompanied by a revision of the theory that the payment of premiums on life insurance is so important an expenditure for the average taxpayer that the income of a trust that relieves him of that expense should be taxed to him even if the policies have been irrevocably assigned.

The A.L.I. proposal for life insurance. The fact that the donee of an existing policy gets the right to obtain its cash surrender value (if any), plus the fact that such an inter vivos transfer is subject to gift tax, led the draftsmen of the American Law Institute's model estate and gift tax law to propose an estate tax provision for insurance that takes a middle route between the 1942-1954 law and the 1954 Code:

> Where the decedent makes an inter vivos transfer of a life insurance policy the gift tax will apply to the transfer. Moreover, the transfer does permit the donee to obtain the present enjoyment of some part of the policy, since he can presently obtain the cash surrender value. The [1942-1954] premium payment test included under the estate tax the entire proceeds of the policy and gave a credit for any gift tax paid. It did not take account of the ability of the donee to obtain the cash surrender value during the decedent's lifetime. The [A.L.I.] Draft, however, proceeds on the premise that recognition should be given to this factor. Thus, suppose a decedent purchased and transferred a paid-up policy which cost $40,000, had a cash surrender value of $60,000 at his death, and had a face amount of $75,000. The gift tax would be imposed on $40,000. If recognition is to be given to the present interest of the decedent, then the estate tax should include only $75,000 less $40,000. Under this view, the entire policy would be subject to the transfer taxes, $40,000 to the gift tax and $35,000 to the estate tax. There would be no gift tax credit. If the policy was not fully paid up and the decedent after the transfer continued to pay the annual premiums, then the amount to be subtracted from the face amount would be the sum of the initial amount subject to the gift tax plus each annual premium, which in turn was subject to the gift tax. In fact, probably only the portion of each annual premium which was reflected in the increase in the terminal reserve value should be counted, since the balance went to the current year's insurance protection. This last limitation would be consistent with the gift tax value counted for the initial transfer. However, those that stress the view that recognition should be given to the ability of the donee to obtain the cash surrender value during the decedent's life also stress that under this approach it is more appropriate to subtract the cash surrender value just prior to the decedent's death. If the donee had acted to obtain this amount, that would have ended the matter and any difference between that value and the amounts previously subject to gift tax would go untaxed.
>
> The fact that the donee does not terminate the policy should not alter the result. Hence, in the above example, it is urged that the estate tax apply to the face amount, $75,000, less the cash surrender value of $60,000 or $15,000. This would leave $40,000 subject to the gift tax and $20,000 not subject to either tax. There would be no gift tax credit.
>
> The Draft in section X2013(b)(2)(A) takes the latter view. Basically it subjects to the estate tax the difference between the face amount and the cash surrender value immediately prior to the decedent's death. [American Law Institute, Federal Income, Estate and Gift Tax Statute 227 (Tent. Draft No. 10, 1955).]

NOEL'S ESTATE v. COMMISSIONER *

39 T.C. 466 (1962)

[Decedent was killed in a plane crash between New York International Airport and Venezuela, a few hours after applying for two policies of air travel accident

* Reversed, 332 F.2d 950 (3d Cir. 1964), on the ground that the contract was a policy of accident, rather than life, insurance.

insurance aggregating $125,000 at a booth maintained by a sales agent for the insurer at the airport. Both applications named his wife as beneficiary. The Internal Revenue Service asserted that the proceeds were includible in the decedent's gross state under §2042.]

RAUM, Judge: . . .

1. At the outset we are met by petitioner's contention that the policies in question are not "policies on the life of the decedent" within the meaning of the statute. Petitioner argues that these policies are of the type often characterized as "accident insurance" or "flight insurance," and do not possess many of the features of what is commonly referred to as "life insurance." But the question raised is no longer open.

A similar contention was rejected some 33 years ago in Leopold Ackerman, 15 B.T.A. 635, where it was held that amounts paid on account of accidental death under accident policies were amounts received "as insurance under policies taken out by the decedent upon his own life" within section 302(g) of the Revenue Act of 1924. The 1954 Code before us, although significantly different in other respects, is substantially identical in relation to the question whether the accident policies constitute "insurance . . . on the life of the decedent." While recognizing that there are distinctions between life insurance and accident insurance, *Ackerman* nevertheless held that both may be "upon the life" of the insured. "In each case the risk assumed by the insurer is the loss of the insured's life, and the payment of the insurance money is contingent upon the loss of life." 15 B.T.A. at 637. It is too late to raise the issue herein. The matter has been settled for too long a period to warrant reexamination. The statutory provisions involved are substantially identical as they relate to this question. We follow *Ackerman* here.

2. We pass therefore to consider whether the insurance proceeds are otherwise covered by section 2042(2). Our inquiry is simply whether in relation to these policies, "the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person." These provisions appeared for the first time in the 1954 Code. Whether the policies were "taken out" by the decedent or whether he paid the premiums are no longer the touchstone of taxibility under the new statute. Both the House and Senate Committee reports accompanying the new legislation contained the following statement:

> This section revises existing law so that payment of premiums is no longer a factor in determining the taxability under this section of insurance proceeds. Insurance proceeds payable to the executor will continue to be taxed as under existing law. This section also requires the inclusion in the decedent's estate of insurance proceeds receivable by all other beneficiaries under a policy on the decedent's life with respect to which the decedent at death possessed any of the incidents of ownership exercisable either alone or in conjunction with any other person. . . .

H. Rept. No. 1337, 83d Cong., 2d Sess., p. A316; S. Rept. No. 1622, 83d Cong., 2d Sess., p. 472.

Did the decedent herein possess any of the incidents of ownership in the two policies before us? An examination of both policies requires an unequivocally affirmative answer. In each policy there is a paragraph entitled "Change of Beneficiary," in each of which the following appears:

> Change of Beneficiary: The right to change of beneficiary is reserved to the Insured and the consent of the beneficiary or beneficiaries shall not be requisite to surrender or as-

signment of this policy or to any change of beneficiary or beneficiaries, or to any other changes in this policy.

It is argued by petitioner that the foregoing provision in the policies was merely "boiler plate," that the decedent did not desire any such right, and that he could not have obtained the policies without such provision. Granted that all this be true, it does not advance petitioner's position. Whether or not the right to change the beneficiary was "boiler plate," it was part of the contractual relationship with each insurance company and defined a legal right of the decedent.[1] The right to change beneficiaries is one of the recognized "incidents of ownership," and accordingly the statute is applicable.

Nor is a different result required by reason of the contention that the decedent's wife paid the premiums or that the policies were "assigned" to her. To be sure, we heard testimony that she paid the premiums, but we were not entirely convinced, and since taxability under the 1954 Code does not depend upon who paid the premiums, we have not made any finding one way or the other as to this matter. To establish an assignment, the decedent's wife testified that the decedent told the clerk at the airport to give the policies to her, that they "now belonged" to her, and that "he had nothing more to do with them." We think that the delivery of the policies to her in such circumstances hardly establishes an assignment. It must be recalled that the policies contained provisions for insurance in respect of various bodily injuries short of death, and in such circumstances we are not convinced that petitioner intended to part with all rights in the policies. Rather, the testimony, even if strictly accurate, suggests merely that the decedent was indulging in a common practice of giving physical possession of the policies to the beneficiary so that, in the event of a fatal accident, she would be in a position to assert her rights under the policies. We do not find that by these oral statements, the decedent intended to make any irrevocable disposition of all his rights under the policies,[2] even assuming that he could legally do so in that manner.[3]

Petitioner makes the further contention that the right to change the beneficiary was illusory since, as a practical matter, the decedent would have been unable to exercise that right during flight. The argument proves too much. The same would be true with respect to any policy of life insurance, and the mere fact that the insured at the moment of death might be temporarily incapacitated from exercising his rights has never been thought to vitiate the effect of such retained rights. . . . Moreover, it must be remembered that the policies were not limited to accident on a one-way voyage; they covered a *round trip*, and in the normal course the right to change the beneficiary would have been meaningful prior to commencement of the return trip. Of course, decedent's wife was in possession of the policies, and to the extent that her acquiescence may have been necessary

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1 This is not a case of erroneous provisions in the policies or the inclusion of provisions which resulted from unauthorized action by an insurance agent, which might have been corrected by reformation of the policies after they were issued. Cf. Schongalla v. Hickey, 149 F.2d 687 (C.A. 2), and National Metropolitan Bank v. United States, 87 F. Supp. 773 (Ct. Cl.), relied upon by petitioner.

2 Compare in this respect Franklin Life Insurance Company v. Falkingham, 229 F.2d 300 (C.A. 7), where the physical delivery of a policy to the insured's wife was held not to be an assignment even where such delivery was accompanied by the following declaration (p. 304): "Here, Honey, is your insurance. Take it and keep it. You are the *beneficiary*. And never let it go, regardless of what happens to me. It is yours."

3 We accordingly do not consider whether such alleged oral assignment would have been valid under the law of New York where the delivery of the policies occurred and where such assignment was alleged to have taken place. Cf. McNamee v. Griffin, 285 App. Div. 886, affirmed 309 N.Y. 864; Katzman v. Aetna Life Ins. Co., 285 App. Div. 446, reversed 309 N.Y. 197.

in order to effectuate a change of beneficiary such circumstances would not render the statute inapplicable. For, the statute speaks in terms of incidents of ownership "exercisable either alone or in conjunction with any other person." And the unrestricted words "in conjunction with any other person" include persons having an adverse beneficial interest. Helvering v. City Bank Farmers Trust Co., 296 U.S. 85; Hall v. Wheeler, 174 F. Supp. 418, 421 (D. Maine).

We hold that the proceeds of the two policies in controversy are includable in the decedent's gross estate.

NOTE

1. *Payment of premiums by beneficiary or third person.* Is there any constitutional objection to including the proceeds of an insurance policy in the insured's gross estate because he possessed one or more of the incidents of ownership, if the premiums were paid by the beneficiary or a third person? What if the decedent could exercise the incidents of ownership only with the consent of the beneficiary? Should the decedent in such cases be viewed as having a power of appointment over property created or transferred by someone else, with the tax results depending on the rules that govern powers of appointment? As will be seen (infra p. 1264), the decedent's gross estate does not include property over which he has a power of appointment unless he can exercise it in his own favor, and even then the property is excluded if he must act in conjunction with the person who created the power or with a person who has a substantial adverse interest in the property.

2. *Unwanted incidents of ownership.* With the "reformation" cases cited in footnote 1 of the opinion in *Noel's Estate,* see Piggott's Estate v. Commissioner, ¶63,061 P-H Memo T.C. (policy payable to decedent's family corporation; held, proceeds includible because decedent retained right to change beneficiary, even though retention may have been inadvertent); Hall v. Wheeler, 174 F. Supp. 418 (D. Me. 1959) (accord). See also Regs. §20.2042-1(c)(2) ("incidents of ownership" include power to change beneficiary reserved to corporation of which decedent is sole shareholder).

If the proceeds of a policy payable to the decedent's corporation are included in his gross estate under §2042, can they also be taken into account by the government in valuing the stock of the corporation includible under §2033?

3. *Life insurance as community property.* If the premiums on a life insurance policy are paid with community property, the proceeds will ordinarily constitute community property under local law, and only one half will be includible in the insured's estate under §2042 even though he reserved the incidents of ownership. See Regs. §20.2042-1-(c)(5) and (b)(2). Between 1942 and 1948, when the "economic source" rule (supra p. 1110) was in force, the proceeds of life insurance were ordinarily includible in full in the husband's estate, if the premiums were attributable to his personal earnings and he predeceased the beneficiary. With the repeal of the economic source rule in 1948, local law has controlled the gift tax, as well as estate tax, consequences of community property life insurance: thus, a gift of a community property life insurance policy to a child is treated as made one half by each spouse. See generally Thurman, Federal Estate and Gift Taxation of Community Property Life Insurance, 9 Stan. L. Rev. 239 (1957); Commissioner v. Chase Manhattan Bank, 259 F.2d 231, 244-255 (5th Cir. 1958).

When local community property law regained its primacy in this area in 1948, the common law states were compensated by the marital deduction and "split-gift" provisions discussed infra page 1286.

4. *Apportionment of estate tax against beneficiaries of life insurance.* As early as 1919, Congress provided that the beneficiaries of includible life insurance must pay their share of the federal estate tax to the executor, unless the decedent's will directs otherwise, so that the legatees and other recipients of the decedent's probate estate will not have to bear the full weight of the tax resulting from the inclusion of insurance in the gross estate. See §2206 (infra p. 1354).

FIDELITY-PHILADELPHIA TRUST CO. v. SMITH
356 U.S. 274 (1958)

MR. CHIEF JUSTICE WARREN delivered the opinion of the Court.

The question before the Court is whether the proceeds of certain insurance policies on the life of the decedent, payable to named beneficiaries and irrevocably assigned by the insured, should be included in the estate of the decedent for the purposes of the federal estate tax. The facts are not in dispute. In 1934 decedent, then aged 76, purchased a series of annuity-life insurance policy combinations. Three single-premium life insurance policies, at face value of $200,000, $100,000, and $50,000, respectively, were obtained without the requirement of a medical examination. As a condition to selling decedent each life insurance policy, the companies involved required decedent also to purchase a separate, single-premium, nonrefundable life annuity policy. The premiums for each life insurance policy and for each annuity policy were fixed at regular rates. The size of each annuity, however, was calculated so that in the event the annuitant-insured died prematurely the annuity premium, less the amount allocated to annuity payments already made, would combine with the companion life insurance premium, plus interest, to equal the amount of insurance proceeds to be paid.[1] Each annuity policy could have been purchased without the insurance policy for the same premium charged for it under the annuity-life insurance combination.

The decedent's children were primary beneficiaries of the insurance policies; the Fidelity-Philadelphia Trust Company, as trustee of a trust established by decedent, was named beneficiary of the interests of any of decedent's children who predeceased her. In the year of purchase, decedent assigned all rights and benefits under two of the life insurance policies to her children and under the other to the Fidelity-Philadelphia Trust Company as trustee. These rights and benefits included the rights to receive dividends, to change the beneficiaries, to surrender the policies, and to assign them. Dividends were received, but, as far as the record discloses, none of the other rights was exercised. A gift tax on these transfers was paid by the decedent in 1935. In 1938 decedent amended the above-mentioned trust so that it became irrevocable. As the Government concedes, the decedent retained no beneficial or reversionary interest in the trust.

The insured died in 1946. The proceeds of the three insurance policies were not included in her estate in the estate tax return. The Commissioner of Internal Revenue determined that these proceeds should have been included and assessed a deficiency accordingly. The adjusted tax was paid by the executors, and when claim for refund was denied, this action for refund followed. The District Court entered judgment for the taxpayers, but the Court of Appeals for the Third Circuit reversed. 241 F.2d 690. We granted certiorari. 354 U.S. 921.

It is conceded by the parties that the question of whether the proceeds should be included in the estate is not determinable by the federal estate tax provision dealing with life insurance proceeds. Cf. Helvering v. Le Gierse, 312 U.S. 531. To support the decision below, the Government argues that the proceeds are includible in the estate under [§2036(a), relating to transfers under which the decedent retained the income from the transferred property]. The Government contends that the annuity payments, which were retained until death, were income from property transferred by the decedent to her children through the use of the life insurance policies.

1 Of course, an additional amount is added to the premiums to compensate the insurance companies for expenses.

On the other hand, petitioners, executors of the estate, assert that the annuity payments were income from the annuity policies, which were separate property from the insurance policies, and that since decedent had assigned away the life insurance policies before death, she retained no interest in them at death.

The Government relies on Helvering v. Le Gierse, supra, where this Court also had before it the issue of the taxability of proceeds from a life insurance policy in an annuity-life insurance combination. After holding that the taxability of these proceeds was not to be determined for estate tax purposes according to the statutory provisions dealing with life insurance,[2] the Court held that the proceeds were includible in the estate under Section 302(c) of the Revenue Act of 1926 because they developed on the beneficiaries in a transfer which took "effect in possession or enjoyment at or after . . . death." 312 U.S., at 542. However, in reaching this conclusion the decision did not consider the problem in the case at bar, for in *Le Gierse* the insured had retained the rights and benefits of the insurance policy until death. The facts in the instant case on this point are fundamentally different. Prior to death, the decedent had divested herself of all interests in the insurance policies, including the possibility that the funds would return to her or her estate if the beneficiaries predeceased her. The assignees became the "owners" of the policies before her death; they had received the right to the immediate and unlimited use of the policies to the full extent of their worth. The immediate value of the policies was always substantial. In the year of assignment their total cash surrender value was over $289,000; in the year of death it was over $326,000. Under the assignment, the decedent had not become a life tenant who postpones the possession and enjoyment of the property by the remaindermen until her death.[3] . . . On the contrary, the assignees held the bundle of rights, the incidents of ownership, over property from which the decedent had totally divorced herself. . . .

Illustrative of the distinction between Helvering v. Le Gierse and the case at bar is the fact that the Government has not endeavored here to sustain the tax under the statutory provision applied in that case. Instead of the provision taxing transfers "intended to take effect in possession or enjoyment at or after" the transferor's death, the provision applied in Le Gierse, the Government relies on the provision [§2036(a)(1)] taxing transfers in which the transferor has retained until death "the right to income from" the transferred property. However, the Government's position that the annuities were income from property which the insured transferred to her children under the life insurance policies is not well taken.

To establish its contention, the Government must aggregate the premiums of

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2 Section 302(g) of the Revenue Act of 1926 exempted from the estate proceeds up to $40,000 "receivable . . . as insurance" by persons other than the executor. The proceeds in Helvering v. Le Gierse were not considered to have arisen from "insurance" as Congress meant the word to be used because the ordinary "insurance risk" was not present. The insurance company had not undertaken to shift the risk of premature death from the insured and to distribute the risk among its other policyholders. On the contrary, by requiring a concurrent purchase of a nonrefundable annuity contract, the company had neutralized the risk at the expense of the "insured." The remaining risk, whether the annuitant would live beyond the actuarial prediction and after the insurance policy had been surrendered, was considered not an insurance risk but a risk of ordinary investment. . . .

3 Nor are the assignees like second annuitants in survivorship annuities or joint annuitants in joint and survivor annuities. The doner's and donee's annuities have a common fund as the source so that if the source of the donor's annuity is extinguished, the donee's annuity is destroyed. The entire economic enjoyment of the second annuitant must, realistically speaking, await the death of the first annuitant, and a substantial portion of the surviving joint annuitant's enjoyment is similarly postponed. Cf., e.g., Commissioner v. Wilder's Estate, 118 F.2d 281; Commissioner v. Clise, 122 F.2d 998; Mearkle's Estate v. Commissioner, 129 F.2d 386.

the annuity policies with those of the life insurance policies and establish that the annuity payments were derived as income from the entire investment. This proposition cannot be established. Admittedly, when the policies were purchased, each life insurance-annuity combination was the product of a single, integrated transaction. However, the parties neither intended that, nor acted as if, any of the transactions would have a quality of indivisibility. Regardless of the considerations prompting the insurance companies to hedge their life insurance contracts with annuities, each time an annuity-life insurance combination was written, two items of property, an annuity policy and an insurance policy, were transferred to the purchaser. The annuity policy could have been acquired separately, and the life insurance policy could have been, and was, conveyed separately. The annuities arose from personal obligations of the insurance companies which were in no way conditioned on the continued existence of the life insurance contracts. These periodic payments would have continued unimpaired and without diminution in size throughout the life of the insured even if the life insurance policies had been extinguished.[4] Quite clearly the annuity payments arose solely from the annuity policies. The use and enjoyment of the annuity policies were entirely independent of the life insurance policies. Because of this independence, the Commissioner may not, by aggregating the two types of policies into one investment, conclude that by receiving the annuities, the decedent had retained income from the life insurance contracts.

Accordingly, the judgment of the Court of Appeals is

Reversed.

MR. JUSTICE BURTON with whom MR. JUSTICE BLACK and MR. JUSTICE CLARK join, dissenting.

For the reasons stated by the court below, 241 F.2d 690, and also in Conway v. Glenn, 193 F.2d 965, and Burr v. Commissioner, 156 F.2d 871, it seems to me that, for federal estate tax purposes, this case is indistinguishable from one in which a settlor places a sum in trust under such terms that he shall receive the income from it for life, and the principal shall be payable to designate beneficiaries upon his death. As the principal, in that event, would be includable in the settlor's estate for federal estate tax purposes, so here the proceeds of the insurance policies should be included in this decedent's estate. Accordingly, I would affirm the judgment of the Court of Appeals.

NOTE

1. *Life insurance-annuity combination.* If the transferred insurance policies included an option under which the beneficiaries would be paid an annuity, could its value be included in the insured's gross estate under §2039 of the 1954 Code?

If the insured died within three years after transferring the insurance policies, would §2035 be applicable?

2. *Other problems in defining "insurance."* In Commissioner v. Treganowan, 183 F.2d 288 (2d Cir. 1950), cert. denied, 340 U.S. 853, the court had to say whether the gross estate included a "death benefit" of $20,000 paid to the decedent's widow by the "Trustees of the

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[4] Where a decedent, not in contemplation of death, has transferred property to another in return for a promise to make periodic payments to the transferor for his lifetime, it has been held that these payments are not income from the transferred property so as to include the property in the estate of the decedent. E.g., Estate of Sarah A. Bergan, 1 T.C. 543, acq., 1943 Cum. Bull. 2; Security Trust & Savings Bank, Trustee, 11 B.T.A. 833; Seymour Johnson, 10 B.T.A. 411; Hirsh v. United States, 35 F.2d 982 (Ct. Cl. 1929); cf. Welch v. Hall, 134 F.2d 366. In these cases the promise is a personal obligation of the transferee, the obligation is usually not chargeable to the transferred property, and the size of the payments is not determined by the size of the actual income from the transferred property at the time the payments are made.

Gratuity Fund" of the New York Stock Exchange, of which the decedent had been a member:

> Since 1873 the Exchange has had a plan providing for the payment by the surviving members of a certain sum to the families of deceased members. The constitution of the Exchange sets up for this purpose a Gratuity Fund and provides that before any one may be elected to membership in the Exchange he must make a contribution to the Gratuity Fund of $15. By the constitution the member also "pledges himself to make, upon the death of a member of the Exchange, a voluntary gift to the family of each deceased member in the sum of fifteen dollars." The constitution also pledges the faith of the Exchange to pay, out of these assessments, $20,000, or so much thereof as may have been collected, to the persons named in the next section of the document. The persons there named were the widow and children of the member or issue of a deceased child or children, or if he died leaving neither widow, child, nor issue of a child, then to his legal heirs or the persons who would, under the laws of New York, take the same by reason of relationship to him had he owned the same at the time of his death. No member has at any time had the right to name, select, or designate any beneficiary or beneficiaries other than those named above, nor may the proceeds be assigned or pledged for the payment of any debt.
>
> Although the constitution provides that the beneficiaries of a deceased member are to receive the full $20,000 only if that amount is collected, practically it is certain that the full amount will be paid. Under Art. X, §5, of the constitution of the Exchange, members are subject to loss of their seats for failure to meet any assessment, including the contribution due on decease of a member. [183 F.2d at 289.]

Was the "death benefit" insurance? If so, did the decedent have any of the incidents of ownership within the meaning of §2042?

See Rev. Rul. 57-54, 1957-1 C.B. 298, regarding a contract of insurance under which the insurer agreed to pay the owner of an airplane all sums which the latter might become liable to pay by reason of liability for accident to any passenger, provided the passenger or his representatives executed a full release of all claims for damages against the insured. The Internal Revenue Service ruled that the amounts received by the personal representatives of a deceased passenger are not insurance within the meaning of §2042(1), even though paid without proof of the insured's legal liability for the passenger's death. The ruling goes on to say:

> However, if the contract between the insurance carrier and the owner of the airplane had provided that the insurance company would unconditionally pay an agreed amount to the estate of any passenger who died as a result of an accident while a passenger on the airplane, the acceptance of such amount would have constituted insurance receivable by the executor of the decedent's estate and includible in the decedent's gross estate for Federal estate tax purposes under section 2042 of the Code.

If under local law the proceeds of such a policy would serve to mitigate the damages for which the insured might be liable, is the ruling correct? What if the proceeds were payable to the insured's next of kin? Does Goodman v. Granger, supra page 1084, have any bearing on these questions?

2. *Policies Owned or Paid for by Decedent on Life of Third Person*

Section 2042 is concerned only with "policies on the life of the decedent," and has no application to policies owned or paid for by the decedent on the life of another person. If the decedent owns such a policy at the time of his death, its value will be includible in the gross estate by virtue of §2033. See Du Pont's Estate v. Commissioner, 233 F.2d 210 (3d Cir. 1956), cert. denied, 352 U.S. 878, rejecting the theory that the amount includible under §2033 is limited to the policy's cash surrender value and applying instead the gift tax valuation princi-

ples of Guggenheim v. Rasquin, supra page 1248. Even if the decedent did not own the policy at death, however, it may be includible in his gross estate because he transferred it during his lifetime in a taxable manner, as the following case demonstrates.

PYLE'S ESTATE v. COMMISSIONER

313 F.2d 328 (3d Cir. 1963)

Before STALEY, HASTIE and SMITH, Circuit Judges.

HASTIE, Circuit Judge.

The Tax Court has held that the proceeds of an insurance policy on the life of Wallace Pyle are includible in the gross estate of his widow, Ida Pyle, who has since died, as property which she transferred, reserving a life estate, within the meaning of section 2036 of the 1954 Internal Revenue Code. This ruling resulted in a determination of an estate tax deficiency. The executor of Mrs. Pyle's estate has brought the case here for review.

Mrs. Pyle applied for and obtained a $30,000 insurance policy on her husband's life, payable on his death to her. The policy granted Mrs. Pyle all the rights accorded the "insured" under the policy and she was the named beneficiary. Thus, it is clear that when the policy was issued Mrs. Pyle alone enjoyed the various incidents of ownership, including the rights of borrowing, assignment and cash surrender. She also had the right to change the beneficiary and to elect among settlement alternatives.

At Mrs. Pyle's request, during the life of her husband, a rider was attached to the policy providing that, upon the death of the insured husband, the proceeds would be retained by the company which would pay Mrs. Pyle 3% interest thereon, plus dividends, for the remainder of her life. Thereafter, the earnings, and ultimately the proceeds of the policy, were to be paid to her children. Mrs. Pyle reserved the right to revoke and change this revised method of settlement until the death of her husband, but did not do so. Upon the husband's death, the revised scheme of settlement became irrevocable.

Section 2036 of the 1954 Code requires that there shall be included in the gross estate of a decedent the value of "any interest [in property] . . . of which the decedent has at any time made a transfer . . . under which he has retained for his life . . . the right to income from, the property . . ." The Tax Court concluded that, in the circumstances outlined above, Mrs. Pyle's action during the lifetime of her husband in changing the disposition to be made of the proceeds of the life insurance policy upon maturity constituted a transfer of property under which she retained a life estate.

Challenging this conclusion, the petitioner argues that it was the death of the insured husband rather than the earlier action of Mrs. Pyle which in legal contemplation effected the transfer of property. The fact that Mrs. Pyle's election as to the disposition of proceeds at maturity was revocable until her husband died and that interests in such proceeds were contingent or inchoate until her husband's death are thought to support this contention.

We think petitioner's argument is unsound. The only transfer of property with which we are concerned is the transfer of the right to receive proceeds upon maturity. That transfer could be accomplished only through the exercise of ownership rights created by the terms of the policy and vested exclusively in Mrs. Pyle from the date of issuance until her husband's death. The fact that the husband's death was the event which caused the policy to mature and made Mrs. Pyle's election as to changes in the disposition of the proceeds irrevocable did not make him a transferor. For he had no power over the disposition of the pro-

ceeds during his lifetime and no interest in them which could pass to another at his death. An instructive analogy is provided by Goodnow v. United States, Ct. Cl., 1962, 302 F.2d 516, where a wife was held not to have been the transferor of the proceeds of a policy on her husband's life because he was the legal owner of the policy, with a vested right to elect among optional dispositions of the proceeds. As concerns the proceeds, the position of the husband there was essentially the position of the wife here.

Petitioner also points out that some of the premiums on the policy were paid by the husband. But certainly this gave him no interest in and no power over the disposition to be made of the proceeds upon his death. That is the only transfer which is relevant here. There are other cases, notably Estate of Susie C. Haggett, 1950, 14 T.C. 325, acq., 1950-2 Cum. Bull. 2, upon which petitioner relies, in which the original purchase of insurance or an annuity was a transaction constituting a transfer of property which was to become effective in some degree only upon the purchaser's death. The present case is different because it was neither the original purchase of insurance nor the payment of premiums which in fact or in law accomplished the decisive shifting of the right to proceeds. Those transactions are simply irrelevant.

Here again, Goodnow v. United States, supra, is helpful. For in that case the wife paid certain premiums on policies on her husband's life, but the husband was vested with ownership rights in the policies, including control over the disposition of proceeds. In these circumstances, the wife's payment of premiums did not make her a transferor of any property interest in the policies.

It remains only to consider whether Mrs. Pyle's election of an alternative disposition of the proceeds was such a transaction as amounts to a transfer of property with a retained life estate, within the meaning of section 2036. Mrs. Pyle was the beneficiary originally named in the policy and as such was entitled to receive the entire proceeds of the policy on her husband's death. Then, as was her right under the terms of the policy, she caused the dispositive provisions of the policy to be changed so that she would receive only interest on the proceeds during her life, with ownership and enjoyment of this property passing to other designated persons upon her death. If it had been after maturity that Mrs. Pyle gave up her absolute right to the proceeds of the policy and elected instead to receive income for life with remainder to others, the transaction would clearly have been a transfer of property within section 2036. Estate of John Joseph Tuohy, Jr., 1950, 14 T.C. 245; Estate of Mabel E. Morton, 1949, 12 T.C. 380. This case is different only in two respects. Mrs. Pyle acted while enjoyment of her right to the proceeds was still prospective and contingent upon her husband's death. Thereafter, so long as her husband lived, she could have revoked her action. While such circumstances may affect the time when in legal contemplation the transfer is accomplished, they do not make the actor any less a transferor of an interest in property. Cf. Adele F. Goodman, 1944, 4 T.C. 191, aff'd, 2d Cir., 1946, 156 F.2d 218, 166 A.L.R. 444.

NOTE

1. *Pyle's Estate.* If the trust had been created by a transfer of existing policies by the decedent's husband, and the decedent had thereafter paid the premiums (e.g., because of a fear that payment by him would constitute transfers in contemplation of death), would anything have been includible in her estate under §2036(a)? In Goodnow's Estate v. United States, 302 F.2d 516 (Ct. Cl. 1962), cited in *Pyle's Estate,* nothing was included in the wife's estate despite her payment of the premiums on policies so transferred:

> It is clear, of course, that Mrs. Goodnow transferred, either directly or indirectly, the requisite funds for the payment of premiums. She was also entitled, under the

express terms of the trust instrument, to the income from the insurance proceeds for life. The relevant inquiry here is, granting the transfer of property, whether her life estate under the trust amounts to a *retention by her* of a life estate *in the property she transferred*. It does not. She herself retained no interest in the funds she transferred. She did have a contingent life interest in the income from the insurance proceeds. This interest, however, was not retained by her in the funds she provided for the payment of premiums. It was granted to her by the express terms of the trust instrument executed by her husband. Further, there is no indication that the Goodnows agreed sub rosa that she should have a life estate in the trust income if she would make the requisite premium payments. This is particularly true in view of the fact that the trust instrument, as originally written, provided that Mrs. Goodnow's interest would terminate upon her subsequent remarriage.

In addition to the necessity of finding that Mrs. Goodnow *herself* retained a life interest in the property she transferred, it is also necessary to find, under section 2036(a)(1), that she retained the life interest in the *same* property she transferred. In other words, assuming *arguendo* that Mrs. Goodnow herself retained a life interest, the question then becomes whether she had a life interest in the premium payments she transferred. In order to justify such a conclusion, we would have to hold that, as a matter of law, the premium payments and the income from the insurance proceeds are one and the same. That this is obviously not the case may be seen from the fact that there is no necessary relationship between the premiums and the ultimate investment income. The premiums were not simply funnelled through the insurance companies and returned to Mrs. Goodnow in another form. Rather, they were received by the insurance companies as the consideration for the promises contained in the insurance contracts. If there was any funnelling process at all, it ceased when the funds were received by the companies. [302 F.2d at 520-521.]

The trust in *Goodnow's Estate* was revocable by the husband throughout the period of his wife's premium payments and until his death. Would this fact have been a more persuasive reason for reaching the court's result? If the trust in *Goodnow's Estate* had been irrevocable, would the rationale of *Pyle's Estate* have led to a different result?

Should the payment of premiums by either the insured or his wife in *Pyle's Estate* have been treated as gifts for gift tax purposes? See Commissioner v. Berger, 201 F.2d 171 (2d Cir. 1953).

2. *References.* Wilkinson, Life Insurance and Estate Planning Tax Aspects, 38 Texas L. Rev. 167 (1959); Yohlin and Bomze, Some Unresolved Gift and Estate Tax Problems of the Unfunded Irrevocable Insurance Trust, 41 Taxes 521 (1963); Swihart, Federal Taxation of Life Insurance Wealth, 37 Ind. L.J. 167 (1962); Brown and Sherman, Payment of Premiums as Transfers in Contemplation of Death, 101 Trusts & Estates 790 (1962); Comment, The Life Insurance Trust in Estate Planning, 34 Miss. L.J. 81 (1962); Oberdorfer, Gift Tax Problems in Transfers of Life Insurance, 15 N.Y.U. Inst. on Fed. Taxation 237 (1957).

Section B. Powers of Appointment: §2041

Chapters 12 and 13 of this book are concerned primarily with property that the decedent either owned when he died or transferred during his life by testamentary disposition. This section concerns itself with the taxability of property which the decedent never owned but over which he had a power of appointment. In Helvering v. Safe Deposit & Trust Co., supra page 1098, it was pointed out that the Revenue Act of 1916 said nothing about property over which the decedent had a power of appointment, and that United States v. Field, 255 U.S. 257 (1921), held that such property was not the "property" of the decedent within the meaning of the predecessor of §2033. The court also held that such property was not reached by the postponed-possession-or-enjoyment clause because that clause embraced only transfers of the decedent's own property.

The Revenue Act of 1918. The 1916 omission was remedied by the Revenue

Act of 1918, providing for the inclusion in the decedent's gross estate of "any property passing under a general power of appointment exercised by the decedent (1) by will, or (2) by deed executed in contemplation of, or intended to take effect in possession or enjoyment at or after, his death . . ." * Because the property was not subject to the estate tax under the 1918 provision unless the power was exercised, the holder of the power (the "donee") could enjoy the control of an absolute owner with impunity. Helvering v. Safe Deposit & Trust Co., supra page 1098. For example, the head of a family could transfer his entire fortune in trust, giving his son the income for life and a general power of appointment over the corpus and designating his grandchildren as takers in default. The son's estate would not be taxed on the corpus, despite his dominion and control over it, if he was content to have it go to the takers in default. Moreover, if the son's power was not a "general" power of appointment, he could exercise it without incurring estate tax liability. Thus, if in the example just given the son's power was a power to appoint only to his wife or children, the property would not be included in his estate even if he exercised the power. In Clauson v. Vaughan, 147 F.2d 84 (1st Cir. 1945), a son was given a power to appoint to anyone except his wife (from whom he was later divorced) and her family. Admitting that "a trivial or fake limitation obviously imposed for the purpose of tax evasion" might be ignored, the court held that the power in question was not "general" even though the son could appoint to anyone in the world, including himself, so long as none of the property went directly or indirectly to his first wife or her family.

Statutory reform: the 1942 legislation. In 1942, the powers of appointment provision was completely revised. The 1942 legislation made economic power or dominion, rather than actual exercise of the power, the criterion for taxing property subject to a power of appointment: the property was includible if the decedent possessed a power of appointment at the time of his death, whether he exercised it or not. In reaching unexercised powers, the 1942 legislation was analogous to §2038, which reaches property transferred by the decedent if he retains a power over it until his death. The 1942 provision also taxed property of the decedent during his life if he exercised or released a power of appointment in contemplation of death or by other testamentary disposition. In addition to abandoning the 1918-1942 dichotomy between exercised and unexercised powers, Congress in 1942 adopted a statutory definition of the term "power of appointment," instead of leaving to the courts the determination of what powers were sufficiently "general" to be subject to tax. Under the 1942 law, the term "power of appointment" meant any power to appoint exercisable by the decedent alone or in conjunction with another person unless (a) the decedent could appoint only to certain members of his family or of the donor's family or to charities, or (b) the decedent had a quasi-fiduciary power to appoint only within "a restricted class" and could not exercise the power in his own behalf. Special provision was made for powers created on or before October 21, 1942, when the new legislation was adopted. See generally Eisenstein, Powers of Appointment and Estate Taxes: II, 52 Yale L.J. 494 (1943); Alexander, Taxation of Powers of Appointment Under the Revenue Act of 1942, 56 Harv. L. Rev. 742 (1943); Griswold, Powers of

* The Revenue Act of 1932 added, after the quoted language, the following: "or (3) by deed under which he has retained for his life or any period not ascertainable without reference to his death or for any period which does not in fact end before his death (A) the possession or enjoyment of, or the right to the income from the property, or (B) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom; . . ."

Appointment and the Federal Estate Tax, 52 id. 929 (1939); response by Leach, id. 961; reply by Griswold, id. 967.

The Powers of Appointment Act of 1951. The powers of appointment area was again sweepingly revised by the Powers of Appointment Act of 1951, whose rules were carried forward by §2041 of the 1954 Code. The 1951 Act not only rejected in large part the underlying philosophy of the elaborately drafted 1942 statute, but also applied the new rules retroactively for estates whose decedents died between 1942 and 1951.

The reasons for the extensive changes in 1951 were set out as follows by Guterman, The Powers of Appointment Act, 29 Taxes 631, 632 (1951):

> The 1942 amendments were designed to give recognition to the fact that broad powers of appointment, even though not within the common law definition of a general power of appointment, were substantially equivalent to ownership. The amendments came about as a result of the incongruity of treatment of this type of right of disposition of property as against other rights under the estate tax which had been swept into the category of substantial equivalent of ownership. The form of the 1942 amendments created certain burdens in dealing with powers of appointment which were not consistent with the general recognition of their importance and utility in the disposition of property. Thus, for example, the amendments granting immunity from taxation to a nonbeneficial power exercisable by a fiduciary were found to preclude in many cases, except under the most awkward limitations, the naming of executors and trustees who might be closely related to the decedent. Because such fiduciaries frequently had some kind of contingent interest in property subject to the power, there was a possibility of estate tax on the property subject to the power in the fiduciary's estate. In some cases, will draftsmen were impelled to exclude the participation of such close relative in the exercise of any power and to confine the exercise of such power to so-called disinterested trustees, that is, usually persons unrelated to the decedent. This problem was aggravated by the fact that a mere right to invade principal in favor of a beneficiary was by regulation swept within the category of a power of appointment, so that the common provision in a will of this kind created serious dangers of taxation, unless the particular beneficiary came within the limited statutory group in whose favor powers could be held without estate taxation or, as indicated above, unless the right to act in favor of the beneficiary was confined to disinterested trustees. The question of how remote an interest a fiduciary might have and still be subject to the danger of estate tax on a fiduciary power became a subject of much discussion and controversy. This area obviously called for a statutory change.
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> Another problem that arose in connection with the 1942 amendments was the absolute subjection to taxation of any power in a case where the donee of the power created a further power. This provision was primarily designed to avoid, without violating, the provisions of certain state laws whose rules against perpetuities permitted the indefinite creation of powers of appointment from generation to generation.* In this way property

* Since the exercise of a special power of appointment was not subject to tax under the 1942 legislation, A's will could leave his property in trust for his son B, with a power in B to appoint among his issue; B could exercise his power by a testamentary provision directing the income to be paid to his son C for life, with a power in C to appoint among his issue; and this process could be repeated in successive generations. The only restriction on the possibility of indefinitely avoiding the estate tax (except on the first estate), was the rule against perpetuities; and in Delaware, by virtue of a 1933 statute, even this restriction was ineffective because the relevant period was measured from the exercise of a power, rather than from the creation of the first power. This "lawyer's Utopia" — see Leach, Powers of Appointment, 24 A.B.A.J. 807 (1938) — was invaded by the enactment in the 1951 Act of §2041(a)(3), under which the appointive property is includible in the estate of the donee of a power (even though not a "general" power) if he exercised the power by creating another power which under local law can postpone vesting or suspend ownership or alienation of the property for a period that is not related to the date the first power was created.

Query: What if local law provides that successive powers are permissible but that the property must ultimately vest not later than 5 centuries after the first power was created? — ED.

could be indefinitely taken out of subjection to estate tax. In the effort to circumvent this result, certain other types of dispositions were swept within the purview of estate taxation. For example, where the donee of a properly limited power otherwise nontaxable exercised such power by a creation of a trust and provided that the trustee should have the right in his discretion to pay over principal to the beneficiary, the otherwise tax-free power of appointment was rendered taxable, since such right to pay principal is classified as a power of appointment. This result would appear not to have been within the intended purpose of this provision of the law and created a limitation unrelated to tax avoidance and contrary to accepted methods of draftsmanship of wills and trusts.

See also Craven, Powers of Appointment Act of 1951, 65 Harv. L. Rev. 55, 61-64 (1951), which contains an interesting account of the important role played by the American Bar Association in securing enactment of the 1951 Act.

The 1951 Act dealt separately with powers created on or before October 21, 1942 — the period when the statute spoke only of "property passing under a general power of appointment exercised by the decedent" — and those created after that date.

Definition of "general power of appointment": §2041(b)(1). Before we turn to the distinction between pre- and post-1942 powers, a fundamental premise common to both should be noted: only "general powers of appointment" (as defined) are subject to tax. The 1942 statute, as just stated, proceeded on the assumption that the donee of a power should in general be taxed if he had any control over appointive property; the only exceptions were for powers to appoint only among specified close relatives of the donor or to charities and for powers that were "fiduciary" in nature. The 1951 Act adopts the fundamentally contrary premise that the property should be taxed in the donee's estate only if he had a power to appoint to himself, his estate, his creditors, or his estate's creditors.* The "or" in §2041(b)(1) has been construed as disjunctive, so that a power is "general" if the holder can appoint the property either to himself, or to his estate, or to his creditors, or to his estate's creditors. Edelman's Estate v. Commissioner, 38 T.C. 972 (1962). Any power not capable of such an exercise, however, is not a "general power of appointment" no matter how extensive the holder's control over the property, and hence it may be held, exercised, or released free of tax. What is the justification for imposing an estate tax under §2038 on trusts which the decedent had a nonbeneficial power to alter or amend (see Porter v. Commissioner, supra page 1144), while exempting property subject to identical control under a power of appointment?

A power need not be labelled as such to qualify as a general power of appointment within the meaning of §2041. Thus, in Wolf's Estate v. Commissioner, 29 T.C. 441 (1957), aff'd on other issues, 264 F.2d 82 (3d Cir. 1959), an employee's power to designate the recipient of payments under a pension agreement with his employer was treated as a power of appointment; see also Regs. §20.2041-1(b) (term includes all powers "which are in substance and effect powers of appointment regardless of the nomenclature used in creating the power and regardless of local property law connotations"). Was the decedent's power in Goodman v. Granger (supra p. 1084) a general power of appointment?

In an omitted portion of the opinion in Second National Bank of Danville v. Dallman, supra page 1101, the court held that the decedent did not possess a general power of appointment (under 1942-1951 law):

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* But see §2041(a)(3) (exercise of a power by creating another power, where rule against perpetuities is ineffective, is taxable; supra page 1263 note).

[Section 811(f)(3) of the 1939 Code] defines a general power of appointment thus: "For the purposes of this subsection the term *general power of appointment* means a power which is exercisable in in favor of the decedent, his estate, his creditors, or the creditors of his estate . . ." . . . We think it obvious that decedent had no general power of appointment and certainly she was not endowed with power to dispose of the insurance proceeds by will. This power of appointment of which the statute and the cases speak is not something to be plucked out of the air; it must be created before it can be exercised. Decedent's power, such as it was, must be found in the insurance contract between her father and the insurance company and not elsewhere.

The salient provisions of this contract have heretofore been noted and need not be repeated in detail. It is sufficient to state that the sole and only power reposed in decedent was the right to appoint a contingent beneficiary. If this power had been exercised, which it was not, the beneficiary thus appointed would have been entitled to take the insurance proceeds. And even the exercise of this meager power was limited, that is, it was required to be made in "writing and filed at the Home Office of the Company (accompanied by the Policy for suitable endorsement) prior to or at the time this Policy shall become payable." It thus appears plain that as a prerequisite to any valid change of beneficiary, decedent was required not only to nominate but also to take the prescribed steps in order to make such nomination effective, all to be performed prior to her death. This was not done, and as a result the proceeds were payable at decedent's death not by her direction but by that of her father as contained in the contract. There is not so much as an intimation in the contract of any right possessed by decedent to dispose of the proceeds at her death, by will or otherwise. Every vestige of right or interest which decedent had in these proceeds was extinguished by death; nothing passed from her to the executor of her estate. Any exercise of power in this respect by decedent in her testamentary capacity must have been of her own creation; it certainly was not that of her father.

We have examined the many cases called to our attention and we find none where the right to make a disposition of property, testamentary or otherwise, by power of appointment was not derived from a donor. [209 F.2d at 323-324.]

The Internal Revenue Service has announced that it does not accept the *Second National Bank of Danville* case as a precedent in disposing of similar cases. Rev. Rul. 55-277, 1955-1 C.B. 456.

Certain powers that would otherwise qualify as "general" powers are exempted by paragraphs (A), (B), and (C) of §2041(b):

1. *Powers subject to an "ascertainable standard."* A power held by the decedent to consume, invade, or appropriate property for his own benefit is exempt by virtue of §2041(b)(1)(A) if exercisable only under "an ascertainable standard relating to [his] health, support or maintenance." Why this exception? Litigation under §2038 (see Jennings v. Smith, supra p. 1155) and under §2055 (infra p. 1280) foreshadows difficulty with this provision and casts doubt upon the draftsmen's belief that the 1951 provisions made "the law simple and definite enough to be understood and applied by the average lawyer." Senate Finance Committee, S. Rept. No. 382, 82d Cong., 1st Sess. 3. Will a power be exempt if the donee may exercise it "to maintain himself in the style to which he has been accustomed"? In the style to which his family background entitles him "to become accustomed"? In the style "that an annual income of $100,000 would assure"? In Barritt v. Tomlinson, 129 F. Supp. 642 (S.D. Fla. 1955), it was held that an income beneficiary's right "to use all or any part of the principal as she may see fit," was, under local law, exercisable only "to that extent which was necessary for her support," and that it was a restricted power under §2041(b)(1)(A). See also Pittsfield National Bank v. United States, 181 F. Supp. 851 (D. Mass. 1960) (ostensibly unlimited power interpreted as limited by ascertainable standard in light of local law); Snyder v. United States, 203 F. Supp. 195 (W.D. Ky. 1962) (widow's power to consume property held unrestricted by ascertainable standard);

Strite v. McGinnes, 330 F.2d 234 (3d Cir. 1964) (requirement that donee of power act in "good faith" held not to exempt it from category of "general" powers; suggestion that Regulations under §2041 rely too heavily on §2055 cases, relating to charitable deduction).

See Regs. §20.2041-1(c)(2), which serves as a guide to draftsmen who wish to create a power "limited by an ascertainable standard" under §2041(b)(1)(A) of the Code.

2. *Pre-1942 joint powers.* A power created on or before October 21, 1942, is exempt under §2041(b)(1)(B) if exercisable by the decedent only in conjunction with another person. This exemption carries forward the conclusion of a few courts that a joint power could not be "general" under the 1918-1942 law.

3. *Post-1942 joint powers.* A post-1942 joint power is exempt under §2041(b)-(1)(C) if exercisable by the decedent only in conjunction with the donor of the power or a person having a substantial adverse interest. If the person whose consent is required falls into neither of these categories but is a potential appointee, only an appropriate fraction of the property is taxed to the decedent. The concept of a substantial adverse interest — hitherto unknown to the estate tax statute — is given some definiteness by §2041(b)(1)(C)(ii), but for the most part its meaning will have to be developed by analogy from the income and gift tax law. See Camp v. Commissioner, supra page 1164.

Bearing in mind that only property subject to a general power, as just defined, is taxable in any event, we may now turn to the differences under the 1951 Act between pre- and post-1942 powers:

(1) Powers created on or before October 21, 1942.* Property subject to these powers is taxed only if the power is exercised by the decedent by will or by other testamentary disposition. Is a power "exercised" if the donee provides that the property shall go to the taker in default? If the appointees renounce their rights under the appointment? See Regs. §20.2041-1(d); Wilson v. Kraemer, 190 F.2d 341 (2d Cir. 1951), cert. denied, 342 U.S. 859; Moran's Estate v. Commissioner, 16 T.C. 814 (1951); Keating v. Mayer, 236 F.2d 478 (3d Cir. 1956); Gartland's Estate v. Commissioner, 293 F.2d 311 (7th Cir. 1961); McMullin, Estate Tax Effect of Compromised Powers of Appointment, 102 Trusts & Estates 263 (1963).

The student should contrast the divergent approaches of the 1942 and 1951 amendments to pre-1942 powers. Both recognized that some allowance should be made for powers created when the pre-1942 statute was in effect. The 1951 Act provides for a tax only if the power is exercised; the 1942 Act provided for a tax whether the decedent exercised the power or died without exercising it, but allowed a limited period (repeatedly extended by Congress) for releasing the power free of gift tax.

The 1951 Act also provides that if a general power has been appropriately "whittled down" to a non-general power by partial release during the donee's lifetime, his subsequent exercise of the power as thus reduced will not be taxable under certain conditions. §2041(a)(1), last sentence. See Nossaman, Release of Powers of Appointment, 56 Harv. L. Rev. 757 (1943); McCoid, The Non-General Power of Appointment — A Creature of the Power of Appointment Act of 1951, 7 Vand. L. Rev. 53 (1953); Freeman, If This Be Simplification — A View of Pre-1942 Powers of Appointment and the 1954 Internal Revenue Code Section 2041, 40 Cornell L. Rev. 500 (1955).

(2) Powers created after October 21, 1942. Property subject to a post-1942

* For the date of "creation" of a power of appointment, see §2041(b)(3); (date of power created by will); Regs. §20.2041-1(e) (date of power created by inter vivos instrument). The latter provision of the Regulations was promulgated in 1961, following the decision in United States v. Turner, 287 F.2d 821 (8th Cir. 1961); see also Rev. Rul. 63-74, 1963-1 C.B. 176; Berall, Powers of Appointment Created by Revocable Trust or Settlement Option, 101 Trusts & Estates 338 (1962).

power will be taxed if the power is either possessed at death or exercised or released by testamentary disposition.* To this extent, the 1951 Act accepts the premise of the 1942 amendments (and of such other portions of the Code as §2038) that the estate tax should concern itself with the decedent's control over property, whether he exercised it affirmatively or not. On the other hand, §2041-(a)(2) provides that a disclaimer or renunciation of a power shall not be deemed a release, although in point of fact a disclaimer or renunciation, like a release, may be a method of transmitting the property to those whom the donee of the power wishes to benefit. The Congressional reports on the 1951 Act state that the disclaimer or renunciation "must be made within a reasonable time after learning of the power." See Regs. §20.2041-3(d)(6).

Lapse of "general power" during donee's lifetime. Section 2041(b)(2), added by the 1951 Act, deals leniently with the lapse of certain powers of appointment, and may come to have a substantial impact upon estate planning. It sets out as a general principle that the lapse of a power of appointment shall be treated as a release of the power, but provides an exemption for the greater of $5000 per year and 5 per cent of the value of the appointive property. What are the tax consequences, under §2041(b)(2), of these facts: The decedent was the income beneficiary for life of a trust of $200,000 and he had, in addition, the right to withdraw $50,000 from the corpus, this power to lapse on his reaching the age of 50; he died at 65 without having exercised his power? What would be the tax consequences of these facts in the absence of §2041(b)(2)?

The area in which §2041(b)(2) will be most important is the trust under which a widow or child is the income beneficiary with a power to withdraw, say, $5000 per year. What will be included in the gross estate of the widow or child? What would the result have been if §2041(b)(2) had not been enacted? The purpose of this provision is to permit flexibility to be introduced into trust instruments, without tax cost, where the settlor of a trust is afraid that the income alone may prove to be insufficient for the income beneficiary needs. See page 1105 supra. Query: Can this tax-free flexibility be reconciled with the Act's policy of otherwise treating the donee of a general power of appointment as an absolute owner? If §2041(b)(2) were repealed, would a settlor be able to achieve about the same result by giving to the income beneficiary a power of appointment restricted under §2041(b)(1)(A)?

Restricted powers where donee is taken in default. As stated earlier, §2041(b)-(1) defines the term "general power of appointment" to mean "a power which is exercisable in favor of the decedent, his estate, his creditors, or the creditors of his estate." Suppose the power is exercisable only in favor of a restricted class, such as the donee's nieces and nephews, but in default of appointment, the property will go to the donee's estate. With such a power, the donee has as much freedom as though he were expressly empowered to appoint to his estate. Is it a "general power of appointment"? If he dies without exercising the power, can the property be included in his gross estate under §2033, i.e., does he have an "interest therein . . . at the time of his death"? If he exercises the power in favor of his nieces and nephews in contemplation of death, has he made a "transfer" of an "interest" in property under §2035(a)? In this connection, consider again the *Safe Deposit & Trust Co.* case, supra page 1098.

What if the power is exercisable in favor of the donee's wife or minor chil-

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* The Internal Revenue Service has ruled that a post-1942 power is taxable under §2041(a)(2) even though the holder was unable to exercise it, by reason of mental incapacity, from the time the power was created until his death. It was apparently assumed that the power could have been exercised, on behalf of the holder, by the appropriate local court. Rev. Rul. 55-518, 1955-2 C.B. 384; see also Edelman's Estate v. Commissioner, 38 T.C. 972, 977 (1962) (accord, where donee of power was not an adjudicated incompetent).

dren? See Regs. §20.2041-1(c) (a power exercisable "for the purpose of discharging a legal obligation of the decedent or for his pecuniary benefit is considered a power of appointment exercisable in favor of the decedent or his creditors"); cf. *Dwight's Estate*, supra page 1188.

A related problem is presented by the so-called "reverse power." Suppose Smith is the remainderman of a trust created by his father, and that he is empowered to advance principal to the life beneficiary. If he refrains from exercising his power, his estate will include either the entire corpus or his remainder interest, depending upon whether he survives or predeceases the income beneficiary. Does this mean that his power to advance principal to the income beneficiary is, in substance, a general power of appointment because by refraining from exercising it he may acquire the entire corpus? See Johnson, Powers of Appointment, 29 Taxes 965, 977-978 (1951).

Insurance on decedent's life: §2041 vs. §2042. Under §2042(2), the decedent's gross estate includes the proceeds of life insurance on his life if he possessed at his death any of the incidents of ownership, even though he paid none of the premiums (supra p. 1247). If his wife paid the premiums and he had the power to change the beneficiary with her consent, §2042(2) requires the proceeds to be included in his estate — but note that if he had a similar power over some other type of property, it would not be a "general power of appointment" by virtue of §2041(b)(1)(C)(i) (power exercisable only in conjunction with creator of the power). Is there a similar disparity between §2042(2) and §2041 as respects a power to appoint within a class of persons? Such a power is not a general power of appointment if the holder cannot appoint to himself, his estate, his creditors, or the creditors of his estate. Does it constitute an "incident of ownership" within the meaning of §2042(2)? Is there any reason to tax the insured who did not pay for an insurance policy because he possesses an incident of ownership if a comparable power of appointment would not have resulted in an estate tax? Can the "incidents of ownership" rule of §2042(2) be avoided by placing the policies in trust, designating the trustee as the beneficiary, and giving the insured a non-general power to appoint the corpus of the trust? See Estate of Karagheusian v. Commissioner, 233 F.2d 197 (2d Cir. 1956) (decedent's power to alter life insurance trust created by his wife treated as an incident of ownership in insurance policy held by trust to avoid sanctioning tax avoidance "by means of insubstantial alterations in the forms of ownership").

Allocation of tax burden to appointive property: §2207. Because the 1942 legislation imposed an estate tax on some powers of appointment that the decedent could not have exercised for his own benefit, a provision was enacted to protect the natural objects of his bounty by allocating an appropriate portion of the estate tax to the appointive property. Such a provision became less necessary with the 1951 revision; since appointive property is now includible only if the decedent could have appointed to himself, his creditors, his estate, or his estate's creditors, the holder of a taxable power can protect his family by an inter vivos or testamentary exercise of the power to the extent necessary to exonerate his own property from the burden of the tax. Even so, the provision has been carried forward as §2207 of the 1954 Code. It is similar to §2206, allocating the estate tax burden caused by the proceeds of life insurance to the beneficiaries, supra page 1254.

Income tax basis. Before 1954, property subject to a power of appointment took on a new income tax basis on the death of the donee of the power if it passed under a general power exercised by will, under what is now §1014(b)(4). Section 1014(b)(9) of the 1954 Code, however, extended the principle of a stepped-up (or stepped-down) basis to any property acquired "from the decedent by rea-

son of death, form of ownership, or other conditions (including property acquired through the exercise or non-exercise of a power of appointment)" if the property was includible in the donee's estate. Would this cover property acquired when the decedent-donee released his power?

Powers of appointment and the gift tax. Before 1942, there was no specific mention of powers of appointment in the gift tax provisions of the Code. A leading case held that the exercise of a power of appointment did not constitute a taxable gift by the donee, primarily because the Supreme Court had held in the *Field* case, supra page 1261, that appointive property was not includible in the donee's gross estate in the absence of specific legislation. Commissioner v. Walston, 168 F.2d 211 (4th Cir. 1948). But other cases pointed in the opposite direction and the Regulations adhered to the approach of these cases. Cerf v. Commissioner, 141 F.2d 564 (3d Cir. 1944); Richardson v. Commissioner, 151 F.2d 102 (2d Cir. 1945), cert. denied, 326 U.S. 796; Regs. 108 §86.2(b)(7).

In 1942, the gift tax statute was amended to provide explicitly: "An exercise or release of a power of appointment shall be deemed a transfer of property by the individual possessing such power." The new statute went on to provide that the term "power of appointment" did not include powers of the type immune from estate tax under the 1942 law, i.e., powers to appoint only within the donor's or donee's family or to charities, and so-called fiduciary powers. Just as property subject to such limited powers was not part of the donee's gross estate for the estate tax, so it could be routed during the donee's lifetime to an appointee (by exercise of the power) or to a taker in default (by release of the power) without payment of gift tax by the donee.

Quite naturally, the 1951 Powers of Appointment Act swept aside the 1942 provisions governing the gift tax liability of the donee of a power of appointment and substituted principles (embodied without change in §2514 of the 1954 Code) in harmony with the new estate tax provisions. The gift tax now applies, like the estate tax, only to a "general power of appointment," and this term is defined in the same way for both taxes. Next, §2514(b) provides that the exercise or release of a post-1942 power "shall be deemed a transfer of property by the individual possessing such power." (Special provision is made by §2514(a) for pre-1942 powers.) Finally, §2514(e) brings the gift tax into harmony with the estate tax with respect to lapsed powers.

"Reverse powers" and the gift tax. If the donee of a power may appoint only to his nieces and nephews but his estate is the taker in default, does he make a gift by exercising the power in favor of a niece or nephew? We considered earlier, supra page 1268, the question whether the power is a "general power of appointment." The "reverse power" also poses gift tax questions that are parallel to the estate tax questions already raised. Does the income beneficiary of a trust who can advance principal to the remainderman make a gift when he exercises his power? If so, how is the amount to be measured? What of a remainderman who exercises a power to advance principal to the life beneficiary? See Self v. United States, 142 F. Supp. 939 (Ct. Cl. 1956).

Creation of power of appointment: A taxable gift? The statute does not state whether the *creation* of a power of appointment is a taxable gift. If A creates in B a power to appoint to himself, or if he gives B a power to appoint to others and names B as the taker in default, has A made a gift? If A confers on B the power to appoint to C or D, naming X as the taker in default, has A made a taxable gift to B, C, D, and/or X? Is an exclusion allowed under §2503(b)?

Mention has already been made (supra p. 1263n) of §2041(a)(3), under which a non-general power of appointment is subject to the estate tax if it is exercised to create another power in a state in which the rule against perpetuities permits the

indefinite suspension of ownership by the creation of successive powers. In keeping with the special estate tax rule for such powers, §2514(d) provides that the inter vivos exercise of a power by the creation of another power in such a state is to be treated as a gift of the appointive property.

Renunciations, disclaimers, and releases. If A is a legatee under the will of B and renounces his legacy, does he thereby make a gift for gift tax purposes to the residuary legatee or other person who takes the renounced property? In a leading case, it was held that a renunciation by a legatee, in contemplation of death, of an interest in his wife's estate was not a "transfer of property" for estate tax purposes:

> The decedent never owned nor had control of the property as donee. All that he had was a right to accept. Coupled with this right was an equal right to reject. Either could be exercised so long as the estate was in administration. He did reject. The government had no fixed prior right such as a precedent judgment creditor might have had. . . . What it did was to collect a tax, not upon the transfer of an interest in property, but upon the exercise of a right to refuse a gift of property. This we think it had no right to do. [Brown v. Routzahn, 63 F.2d 914, 917 (6th Cir. 1933), cert. denied, 290 U.S. 641.]

The case has often been cited, but other courts have ordinarily applied it only if the taxpayer's renunciation was unequivocal; if there was a partial acceptance of the gift, renunciation of the balance may be treated as a transfer for gift or estate tax purposes. Cerf v. Commissoner, 141 F.2d 564 (3d Cir. 1944); Morton's Estate v. Commissioner, 12 T.C. 380 (1949); see also Fuller v. Commissioner, 37 T.C. 147 (1961) (renunciation after long delay treated as taxable gift). It has also been held that an intestate successor's renunciation is a gift if under state law title vested in him immediately on the intestate's death. Hardenbergh v. Commissioner, 198 F.2d 63 (8th Cir. 1942), cert. denied, 344 U.S. 836. In the *Bergan* case, supra page 1182, it was argued that Miss Bergan had "renounced" her interest in Mrs. Johnson's estate (except for the $50,000 of bonds) within the meaning of Brown v. Routzahn, but the court held that she had transferred this share as consideration for Mrs. Gogin's promise to support her.

Should all renunciations be treated like exercises of a general power of appointment? Note that §2514(b) provides that a renunciation or disclaimer of a power of appointment shall not be treated as a release, i.e., it is not a taxable gift under §2514. See Regs. §25.2514-3(c)(5). See also Kay, Renunciations, Disclaimers, and Releases, 35 Taxes 767 (1957); Lauritzen, Only God Can Make an Heir, 48 Nw. U. L. Rev. 568 (1953); Roehner and Roehner, Renunciation as Taxable Gift — An Unconstitutional Federal Tax Decision, 8 Tax L. Rev. 289 (1953).

References. Craven, Powers of Appointment Act of 1951, 65 Harv. L. Rev. 55 (1951); Guterman, The Powers of Appointment Act, 29 Taxes 631 (1951); Lowndes, Estate Planning and Powers of Appointment, 30 N.C.L. Rev. 225 (1952); Bowe, Estate Tax Planning Under the Powers of Appointment Act of 1951, 5 Vand. L. Rev. 197 (1952).

C H A P T E R 1 5

The Exemption, Deductions, and Credits

Section A. The $60,000 Exemption: §2052

The "gross estate" comprises all of the property described in §§2031-2042, which are examined in Chapters 12-14. The "taxable estate," to which the tax rates set out in §2001 are applied, is defined by §2051 as the "gross estate" less the $60,000 exemption of §2052 and the deductions of §§2053-2056. One other definition is important: the "marital deduction" of §2056 may not exceed 50 per cent of the value of the "adjusted gross estate," a term defined by §2056(c)(2)(A) as the "gross estate" less the deductions permitted by §§2053 and 2054. For estates containing community property, see §2056(c)(2)(B).

An estate tax return must be filed whenever the gross estate of a citizen or resident alien exceeds $60,000, even though no tax is due because of the exemption and deductions. §6018(a)(1). During the calendar year 1961, about 65,000 estate tax returns were filed, of which 19,000 showed no tax due. In the same year, according to the World Almanac, there were 1,700,000 deaths in the United States. Although these figures are not entirely parallel, because the estate tax return is not due until 15 months after death, they do demonstrate that only a small fraction of the population is sufficiently affluent to be concerned about the federal estate tax. The taxable returns filed in 1961 reported aggregate gross estates of about $12.7 billion, aggregate exemptions of about $2.7 billion, and tax liability of about $1.6 billion. The non-taxable returns reported aggregate gross estates of about $1.9 billion.

Before 1954, the estate tax structure consisted of a "basic" and an "additional" estate tax. An exemption of $100,000 was allowed in computing the basic tax, but the exemption for the additional estate tax was $60,000. The only function of the separate computations was to serve as a ceiling on the credit for state death taxes, which was limited, for historical reasons set out infra pages 1325-1326, to 80 per cent of the federal basic tax. The computation of the estate tax was simplified in 1954 by combining the two taxes in §2001, without any change in the total tax due (except for some nonresident aliens). Because some state laws refer to the federal "basic" estate tax, however, §2011(d) provides a method of computing it.

Section B. Expenses, Indebtedness, Taxes: §2053

Section 2053(a) authorizes the deduction of such amounts for funeral expenses, administration expenses, claims against the estate, and unpaid mortgages or other debts in respect of includible property that are allowable by the law of the jurisdiction in which the estate is being administered. (For the proper treatment of community debts in a community property state, see United States v. Stapf, 375 U.S. 118 (1963), holding that only one half of such debts may be deducted from the decedent's half of the community property, even if his will provides for their payment in full.) The deductions may not exceed the value of the property subject to claims under local law, except to the extent that the payments have in

fact been made before the estate tax return is due. See Regs. §20.2053-1(c), Examples (1) and (2). Section 2053(b) supplements §2053(a) by permitting the deduction of expenses incurred in administering property not subject to claims but includible in the gross estate (e.g., trustee's commissions and attorney's fees paid on the termination of an inter vivos trust whose corpus was includible in the gross estate under §2036). To be deductible, §2053(b) expenses must be of a type that would have been deductible under §2053(a) if the property were subject to claims, and they must have been paid before the time for assessment of the estate tax has expired. See Regs. §20.2053-8; Mary E. Burrow Trust v. Commissioner, 39 T.C. 1080 (1963).

Although §2053(a) explicitly (and §2053(b) implicitly) requires claims and expenses for which a deduction is taken to be "allowable" under local law, allowance by the local probate court is not necessary; conversely, it will not ipso facto insure their deductibility. In general, however, a local decree will be accepted, even if rendered by consent "provided the consent was a bona fide recognition of the validity of the claim (and not a mere cloak for a gift) and was accepted by the court as satisfactory evidence upon the merits." Regs. §20.2053-1(b)(2); see also page 1080 supra.

1. *Funeral Expenses*

It has been held that an amount set aside by the decedent's will for perpetual maintenance of a family mausoleum in which she was interred is deductible under §2053(a)(1) if it is allowable as a funeral expense under state law. Estate of Cardeza v. Commissioner, 5 T.C. 202, 220-221 (1945), aff'd, 173 F.2d 19 (3d Cir. 1949); see Igleheart v. Commissioner, 77 F.2d 704, 712-713 (5th Cir. 1935), disallowing a deduction where it was not shown that the amount was allowable under state law. If the decedent makes a bequest for acquisition or maintenance of a family cemetery plot in an amount exceeding what would be allowable under state law in the absence of a bequest, can the excess be treated as an "expense" under §2053(a)(1)?

2. *Administration Expenses*

At the time the estate tax return is filed, the amount of the executor's and attorney's commissions will often be as yet undetermined. The Regulations provide that the deduction may be based upon an estimate of the amount to be paid. Regs. §20.2053-3(b) and (c).

If suit is brought for a refund of federal estate tax, the judgment will bar a later suit for a refund based on the expenses of litigating the first suit. To protect itself, the estate can follow the procedure prescribed by Regs. §20.2053-3(c)(2), which came into the Regulations in 1947. See Bohnen v. Harrison, 232 F.2d 406 (7th Cir. 1956); Frank v. Granger, 145 F. Supp. 370 (W.D. Pa. 1956); and, for historical background, First Nat. Bank of Atlanta v. Allen, 100 F. Supp. 133 (M.D. Ga. 1951).

The Regulations provide that a bequest to the executor in lieu of commissions may not be deducted. §20.2053-3(b). See page 144 supra for the income tax status of such an arrangement, so far as the executor is concerned.

Some administration expenses may also be "ordinary and necessary expenses" incurred in carrying on a trade or business or in producing or collecting income (§§162 and 212), thus qualifying as deductions in computing the estate's *income* tax liability. The executor may not deduct such expenses in the income tax

return unless he waives the right to deduct them in the estate tax return. §642(g). Before 1942, when this subsection was enacted, the possibility existed of deducting some expenses both on the estate tax return as administration expenses and on the estate's income tax return as ordinary and necessary business expenses. See Adams v. Commissioner, 110 F.2d 578 (8th Cir. 1940). Were it not for the enactment of §642(g), this possibility would have been greatly enlarged after 1942 because of the enactment in that year of §212. Section 642(g) does not, however, prevent so-called "deductions in respect of a decedent" from being deducted under §2053 in computing the taxable estate even though they are also deducted under §691(b)(1) on the income tax return of the estate or of the heir who pays them. An example is a §162 or §212 expense that accrued during the decedent's life, but was not deducted by him because he reported his income on the cash receipts and disbursements basis and had not paid the item before his death. The opprobrious connotation of "double deduction" is not applicable to these items, however, because if they had been paid by the decedent during his lifetime they would have reduced both his taxable income and his taxable estate; and allowing them to be deducted under both §2053 and §691(b)(1) produces substantially the same result. See also Mary E. Burrow Trust v. Commissioner, 39 T.C. 1080, 1090 (1963) (deduction of same item in computing taxable income of trust and taxable estate).

The election to deduct expenses on the estate's income tax return rather than on its estate tax return may have important substantive consequences for the decedent's heirs, especially if the amount left to the surviving spouse is fixed by reference to the "adjusted gross estate" as determined for federal estate tax purposes. See Matter of Inman, 22 Misc. 2d 573 (N.Y. 1959); see also Empire Trust Co. v. United States, 226 F. Supp. 623 (S.D.N.Y. 1963); Halbach, Post-Mortem Estate Planning, 1963 U. of Ill. L.F. 212, 246-251; Miller, Check List for Estate Tax Deductions, 102 Trusts & Estates 859 (1963); Holzman, Estate Administration Planning, 39 Taxes 578 (1961).

3. *Claims, Mortgages, and Indebtedness*

COMMISSIONER v. WRAGG

141 F.2d 638 (1st Cir. 1944)

Before MAHONEY and WOODBURY, Circuit Judges, and PETERS, District Judge.

WOODBURY, Circuit Judge.

This is a petition by the Commissioner of Internal Revenue for review of a decision of the Tax Court of the United States holding that there is no deficiency in the federal estate tax paid by the respondent on the Estate of one George H. Lowe, Sr. The statute involved is [§2053(a)(3)].

The Tax Court found the following facts. Between 1883 and 1910 the decedent devoted his time exclusively to the business of Carter, Rice and Co., Inc., and Nashua Gummed and Coated Paper Co., both successful corporations, and during that time the decedent acquired substantial amounts of stock in both of them. This stock was closely held, unlisted and without a ready market.

About 1910 the decedent and his son, George H. Lowe, Jr., organized the Weymouth Art Leather Company, a corporation which engaged in the business of manufacturing a leather substitute by painting cloth. The decedent furnished the original capital for this corporation and served as an officer and a director of it until 1932. He placed his son in charge of its affairs.

During the period from 1917 or 1918 to 1925 the decedent pledged all of his shares of stock in Carter, Rice and Co., Inc., and Nashua Gummed and Coated Paper Co. as collateral to secure various promissory notes for money borrowed from individuals and banking institutions by George H. Lowe, Jr. Some of these notes the decedent also either signed as co-maker or endorsed. A substantial part of the money borrowed by the son and for which the decedent pledged his stocks was used to finance Weymouth. Weymouth was solvent when the loans were negotiated and both the decedent and his son expected that the loans would be repaid.

By 1932 the decedent's health had begun to fail and the various holders of the notes and obligations which had been created by George H. Lowe, Jr. and the decedent were pressing for payment and threatening to sell the shares owned and deposited by the decedent as collateral. In this state of affairs on February 25, 1932, Samuel H. Wragg, the respondent, was appointed conservator of the decedent's estate by the Norfolk County Probate Court. Immediately upon his appointment the conservator brought a petition in the above Probate Court seeking to restrain the various persons and institutions holding collateral notes from selling the collateral, and after hearing on the merits, that court enjoined all parties holding such securities from selling them. When the conservator took office the total obligations for which the decedent had pledged his shares in Carter, Rice and Co., Inc., and Nashua Gummed and Coated Paper Company amounted to approximately $233,000 and the pledged shares had a book value of about double that amount.

For a number of years prior to 1932 the decedent had also given direct financial assistance to his son, some of which the son had from time to time repaid. In 1934, the conservator brought an action in the Municipal Court of the City of Boston against the son for the money advanced directly to him and recovered a judgment therein in the amount of two hundred and forty-five thousand dollars. Execution issued on November 3, 1934, but it does not appear that it was ever levied upon or that anything was ever paid in satisfaction thereof.

During the course of his duties as conservator the respondent refinanced certain of the loans secured by pledge of the decedent's stocks in order to save the equity in those stocks for the estate, it being necessary for him to secure title to the pledged stocks in order to sell them in one block.

George H. Lowe, Sr., died, testate, a resident of Needham, Massachusetts, on February 11, 1937, and his former conservator was appointed and duly qualified as administrator c.t.a.d.b.n. of his estate. In his estate tax return he deducted the amounts due at the date of death, that being the date selected for valuing the estate, on the notes endorsed by his decedent or signed by him as co-maker, or secured by collateral owned by him, and he also deducted the amounts due on notes signed by himself as conservator, the proceeds of which had been used to discharge similar notes. The question is whether these deductions are authorized.

The Commissioner does not question the sufficiency of the evidence to support the Tax Court's finding that "There can be no question as to the bona fides of the several transactions here questioned. Nor is there any doubt as to the obligations being contracted for adequate and full consideration in money or money's worth. All were normal business deals." * Neither does he again urge, as he has so many times in the past, always in vain, that the deductions taken cannot be

* See §2053(c)(1)(A), providing that if a claim against the estate is "founded on a promise or agreement," it may be deducted only if "contracted bona fide and for an adequate and full consideration in money or money's worth," subject to an exception for certain charitable pledges. — ED.

allowed because the consideration for the claims against the estate did not flow to the decedent. . . . His position here, to quote from his brief, is that "The claim and the indebtedness in respect to the property of the decedent were on account of obligations in respect to which the son was primarily liable. The estate, therefore, had a right to indemnity or of contribution against the son. In allowing the deductions here in controversy, the Tax Court erred in ignoring this right of indemnity or contribution from the son. The record does not show nor did the Tax Court find that the son was insolvent or unable to reimburse the estate for the sums paid in satisfaction of the son's indebtedness." That is to say, the Commissioner contends that a bona fide business obligation of a secondary nature undertaken for money or money's worth cannot be deducted for estate tax purposes unless the value of the decedent's right over against the primary obligor is included in computing the gross estate, and since there was no evidence presented to, or finding made by, the Tax Court that the decedent's right over against his son was valueless, the deduction ought not to be allowed because the person claiming a deduction has the burden of proving that he is entitled to it.

The statute makes no specific mention of rights of reimbursement, contribution or indemnity, but it does provide for inclusion in the gross estates of decedents of the value at the time of death of "all property, real or personal, tangible or intangible, wherever situated" [§2031(a)], and these words are clearly broad enough to include such rights. The courts in the cases to be cited hereafter have, at least tacitly, so construed them. The crucial question in cases of this sort is what such a right is worth. If it is worth one hundred cents on the dollar, an estate will not be reduced by a secondary obligation of the decedent, but if it is worth nothing, a secondary obligation will be as effective as a primary one to reduce the net value of an estate. It is upon this truism that the courts and the Board of Tax Appeals appear, if inarticulately, to have proceeded in the past.

Thus when it has appeared that the decedent's right over against the primary obligor was worth its face value, no deduction has been allowed for a secondary liability . . . ; but when it has appeared that the right over was valueless a deduction for it has been allowed. . . . And, when it has appeared that the right was worth something but not its face value a deduction has been allowed to the extent of the amount which actually had to be paid and could not be recovered from the primary obligor by the estate. . . . In view of these cases . . . it does not seem to us that the Tax Court in the case at bar would have allowed the deduction unless it had come to the conclusion that the right of the estate over against the primary obligor, the decedent's son, was valueless. To be sure it made no such finding categorically, but nevertheless we feel that such a finding is implicit in the factual background of the case and that it must have been assumed by the Tax Court that the estate would ultimately have to bear the loss or else it would not have reached the result which it did. The facts upon which we base our conclusion are that at various times the creditors had threatened to sell the collateral pledged to secure the notes; that upon some occasions actions were instituted by creditors against the decedent's estate on the notes, and that the execution on the judgment obtained by the conservator against the son was never levied upon or satisfied although the conservator as a fiduciary was under a legal duty to collect on his judgment, regardless of the family relationship involved, if he could. It seems to us that the creditors would not have taken the steps which they did if the son had been solvent, and that the conservator, if possible, would have collected on his judgment against the son. In the absence of evidence we cannot assume that he neglected to do so in breach of his fiduciary duties. Thus we think that the Tax Court must have concluded, but merely failed to state, that the right of the estate over against the son was value-

less, and, this being so, we see no point in remanding the case for a definite finding to that effect.

The decision of the Tax Court of the United States is affirmed.

NOTE

1. *Right of subrogation.* In DuVal's Estate v. Commissioner, 152 F.2d 103 (9th Cir. 1945), cert. denied, 328 U.S. 838 (1946), where it was argued that the estate's right of subrogation could not be included under §2031 in determining the value of the gross estate because the right would arise only on payment and hence did not exist "at the time of [the decedent's] death" within the meaning of §2031, the court responded:

> Whether the rights over be called a right of subrogation or a right of contribution, or a right to a right of subrogation or contribution, decedent at her death had property rights of value, and the right upon payment [of the principal debt] to acquire the right of subrogation is the property right which must be included in the gross estate. [152 F.2d at 104.]

2. *Consideration that did not augment decedent's estate.* As to the deductibility of a claim founded on a promise or agreement if the consideration "did not flow to the decedent," compare the view of the court in the *Wragg* case with the statement of the Supreme Court in Commissioner v. Wemyss, supra page 1025: "If we are to isolate as an independently reviewable question of law the view of the Tax Court that money consideration must benefit the donor to relieve a transfer by him from being a gift, we think the Tax Court was correct." In Latty v. Commissioner, 62 F.2d 952, 954 (6th Cir. 1933), construing the words "consideration in money or money's worth" in the predecessor of §2053(c)(1)(A), the court said:

> We think that ordinarily these words must be construed to evidence an intent upon the part of Congress to permit the deduction of claims only to the extent that such claims were contracted for a consideration which at the time either augmented the estate of the decedent, granted to him some right or privilege he did not possess before, or operated to discharge a then existing claim, as for breach of contract or personal injury.

Would the claims against the estate in the *Wragg* case have been deductible if the son had been insolvent at the time the decedent endorsed the notes, so that the endorsements were an indirect method of making gifts to the son? See Woody's Estate v. Commissioner, 36 T.C. 900 (1961) (obligation incurred to make a gift is deductible under §2053).

3. *Non-contractual claims.* Since 1932, §2053(c)(1)(A) has required claims against the estate to be supported by full consideration in money or money's worth only if "founded on a promise or agreement." The pre-1932 requirement of full consideration applied to all claims, and thus might have been construed to bar the deduction of a tort claim (e.g., in a personal injury case against the decedent) or a liability imposed by law (e.g., the decedent's unpaid income taxes) on the ground that the claim was not supported by full consideration in money or money's worth.

Note the exception in §2053(c)(1)(A) for charitable pledges; even though the charity's claim is "founded on a promise or agreement," it need not have been contracted for full consideration in money or money's worth. This exemption was enacted in 1942, to overrule Taft v. Commissioner, 304 U.S. 351 (1938), holding that the predecessor of §2053(c)(1)(A) barred a deduction for a claim against the estate arising out of a charitable pledge by the decedent during his lifetime.

GOWETZ v. COMMISSIONER

320 F.2d 874 (1st Cir. 1963)

Before WOODBURY, Chief Judge, and HARTIGAN and ALDRICH, Circuit Judges.

ALDRICH, Circuit Judge.

The question raised in this petition to review a decision of the Tax Court is what deduction may be made from the gross estate of a Massachusetts decedent because of an obligation to pay alimony to his former wife. Prior to a divorce the decedent had entered into a separation agreement to pay $500 a month to his wife for life as long as she remained unmarried. It was not expressly stated that the obligation would continue after the husband's death. The ensuing divorce decree did not in terms incorporate the agreement, but notice was taken thereof and no independent financial provision was made for the wife.[1] In the estate tax return the executors, present petitioners, claimed a deduction in a sizable amount because of the future requirements of the agreement. It is conceded that their figure was supported by accepted actuarial tables as being the fair discounted value, as of the date of decedent's death, of an obligation to pay $500 a month to a woman of the former wife's then age for life or until she remarried. At the same time, vis-a-vis the former wife, they denied all liability, and resisted suit in the state court. No Massachusetts case had passed on the precise question and we accept the executors' assertion that they believed in good faith that there was a reasonable possibility that their defense would be successful. During the pendency of that suit the wife remarried. This, of course, terminated any future rights, and in effect reduced the estate's maximum obligation for monthly payments to a much lower figure than the one indicated by the actuarial tables. Thereafter the executors lost the state court suit, Taylor v. Gowetz, 1959, 339 Mass. 294. The Commissioner limited the deduction to the amount actually payable, and the Tax Court sustained that determination.

Expressly rejecting the broad arguments the government now urges,[2] the Tax Court stated that the executors' total asserted deduction would have been proper, citing Commissioner v. Maresi, 2 Cir., 1946, 156 F.2d 929, had it not been for the fact that the estate's liability was contested. This uncertainty is regarded as fatal. In its opinion the court distinguished uncontested claims with respect to which the amount eventually payable could be approximated by the use of actuarial tables, and "disputed," "contingent" and "potential" claims not so measurable. It described the present claim prior to the final state court decision as "contingent," but rather than saying that initially the deduction was not allowable because it had not been determined that anything would ever be paid, it concluded that until the state court had acted "[t]he value of the claim for deduction purposes was not reasonably ascertainable."

Although we agree with its result we do not altogether adopt the court's reasoning. We question whether, viewing the claim as of the date of death, its value as a claim was necessarily unascertainable. Even a disputed claim may have a value, to which lawyers who settle cases every day may well testify, fully as measurable as the possible future amounts that may eventually accrue on an uncontested claim. If the court was to rest its decision on ascertainable value we think it would have been more appropriate to point out that the executors failed to ascertain it for the reason that in taking a figure based on actuarial tables only, with no allowance for the fact that liability was contested, they made a totally unrealistic appraisal. Obviously a disputed claim is of less value than one which is uncontested.

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1 The government has not contended that the claim is founded on an agreement and to any extent lacked consideration in money or money's worth. See 1954 I.R.C. §§2043(b), 2053(e)(1)(A); Rev. Rul. 60-160, 1960-1 Cum. Bull. 374, modifying E.T. 19, 1946-2 Cum. Bull. 166; cf. Harris v. Commissioner, 1950, 340 U.S. 106; McMurtry v. Commissioner, 1 Cir., 1953, 203 F.2d 659. We are not to be taken as ruling that this was a necessary concession.

2 The government's general approach to unliquidated claims seems andabatarian. We do not find it necessary to pass on it.

The executors are on the horns of a dilemma. If they are correct in saying that Ithaca Trust Co. v. United States, 1929, 279 U.S. 151, requires the claim to be valued as of the date of death irrespective of future events,[3] they have failed to prove its then value. If they wish to relax that principle to the extent of looking to subsequent events to eliminate the question of liability, they cannot object to the government's looking at least that far into the future to remove the other uncertainty.

We need decide no more. At the same time we must observe that the executors' basic position appears in conflict with the statutory scheme, which has frequently been construed to encompass after events rather than to require valuation as of the date of death. See, e.g., Commissioner v. State Street Trust Co., 1 Cir., 1942, 128 F.2d 618; Commissioner v. Shively's Estate, 2 Cir., 1960, 276 F.2d 372; Jacobs v. Commissioner, 8 Cir., 1929, 34 F.2d 233, Jacobs v. Lucas, cert. den., 280 U.S. 603; Estate of William P. Metcalf, 1946, 7 T.C. 153, aff'd without opinion, 6 Cir., May 5, 1947. How far into the future it may be appropriate to go we need not determine.

Judgment will be entered affirming the decision of the Tax Court.

NOTE

1. *Events after death affecting amount "allowable."* In *Shivley's Estate,* described by the court as construing "the statutory scheme . . . to encompass after events rather than to require valuation as of the date of death," the court held that the amount deductible in respect of a similar separation agreement was the amount actually paid between the date of death and the date (one year later) of the ex-wife's remarriage, on the ground that she was not entitled to receive anything more under local law. In the *State Street Trust Co.* case, the ex-wife was entitled to $1000 per month under a divorce decree, but she entered into a "compromise agreement" with the executors under which she received $30,000 plus $650 per month; the court held that the commuted value of the payments due under the compromise, rather than the larger commuted value of the amounts payable under the decree, was deductible. (The opinion does not state whether the "compromise" resulted from a dispute over the validity of the divorce decree.) In *Jacobs* (also cited by the court in the *Gowetz* case), the decedent's widow had a $75,000 claim against the estate under an antenuptial contract, which she relinquished in favor of a bequest of the income for life from $250,000; the court did not allow the estate to deduct either the $75,000 claim or the commuted value of the bequest for which she surrendered the claim. (Under §2053(c)(1)(A) of current law, the claim would be disallowed on the alternative ground that it was founded on a promise but not supported by full and adequate consideration.)

For another reference to post-death events in order to disallow an otherwise allowable deduction, see Rev. Rul. 60-247, 1960-2 C.B. 272 (claim against estate cannot be deducted if it became unenforceable by reason of the creditor's failure to present it for payment within the period specified by local law); cf. Winer v. United States, 153 F. Supp. 941 (S.D.N.Y. 1957) (contra).

2. *Claims arising out of separation and divorce.* Was the claim in the *Gowetz* case "founded on a promise or agreement" within the meaning of §2053(c)(1)(A) so as to be deductible only if "contracted bona fide and for an adequate and full consideration in money or money's worth"? See Harris v. Commissioner, supra page 1036; Commissioner v. Watson, 216 F.2d 941 (2d Cir. 1954) (claim not founded on agreement that was incorporated in later divorce decree, although agreement was to survive divorce); Bowers' Estate v. Commissioner, 23 T.C. 911, 920-923 (1955) (under local law, agreement was independent of decree).

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[3] Ithaca Trust involved the value of a charitable remainder subject to a life estate. The court held that the remainder did not become more valuable, from the standpoint of a deduction from the gross estate, when the life tenant died before reaching her actuarial expectancy.

When the ex-wife's claim is unmistakably "founded on a promise or agreement" (e.g., if there is no decree of separation or divorce), E.T. 19 (supra p. 1033) concedes that a release of support rights constitutes "full and adequate consideration in money or money's worth" to the extent of the value of the support rights. How is E.T. 19 to be applied if a husband's duty to support his wife terminates at his death? Does footnote 1 of the *Gowetz* opinion imply that E.T. 19 cannot be reconciled with §2043(b) (release of marital rights does not constitute, to any extent, consideration in "money or money's worth") and that it is needlessly generous to the taxpayer?

Does §2516 (supra p. 1048) have any bearing on the deductibility of claims in computing the taxable estate? If not, how would the results in this area be changed if there were an estate tax provision parallel to §2516?

Section C. Casualty Losses: §2054

Section 2054 allows the deduction of losses incurred during the settlement of estates "arising from fires, storm, shipwrecks, or other casualties, or from theft," if not compensated for by insurance or otherwise. The specified causes are identical with those in §165(c)(3), supra page 192. A loss that is claimed in computing the estate tax, however, may not be deducted a second time in computing the estate's income tax. §165(c)(3), §642(g).

Section 165(c)(3) is explicitly restricted to losses of *property*. Is §2054 similarly restricted, or could a loss of potential profits, brought on by shipwreck or fire, be deducted from the value of the gross estate? The deduction under §165(c)(3) may not exceed the "basis" of the lost property, by virtue of §165(b); see also Helvering v. Owens, supra page 195. In the case of a loss under §2054, may the full value of property at the time of the loss be deducted, even if by reason of inflation it exceeds the estate tax value? If property declines in value after the date of death, how is the loss to be computed?

In Leewitz v. United States, 75 F. Supp. 312 (Ct. Cl. 1948), cert. denied, 335 U.S. 820 (1948), the court made this comment on §2054:

> At the outset it should be observed that we are here concerned with losses for estate tax purposes where the only losses allowable are those above mentioned, as contrasted with losses allowable for income tax purposes, which include business losses, such as from bad debts, and losses on transactions entered into for profit as well as losses of the kind allowed for estate tax purposes. Only one estate tax return is filed and therefore, once a deduction is allowed, there is no chance for adjustment in another estate tax return in the event there should be some recovery on account of the item for which the deduction was allowed. On the other hand, income tax returns are filed on an annual basis and any recoveries with respect to a deduction allowed in one year will be reflected in income adjustments in a subsequent year. This comparison becomes significant as indicating the nature of the losses which are allowable for estate tax purposes; namely, losses from which no recovery would ordinarily be expected, such as from fires or storms. In addition, these losses have reference to destruction of or damage to physical property where the extent of the loss can be fully measured as of the time the loss is allowed without the necessity for future readjustment. [75 F. Supp. at 317.]

Assuming that a loss did result from casualty, within the meaning of §2054, must the *amount* of the loss be proved with greater accuracy than is required under §165(c)(3)?

A similar problem arises with respect to proof that the loss is not compensated for by insurance or otherwise. The extent of compensation is often undetermined in the year the casualty occurs; in the income tax field, it is only a matter of timing whether the taxpayer holds the item in abeyance until his claim for compensation is settled or deducts the full amount of the loss in the earlier year

and reports the insurance or other recovery as income in the year of settlement. Supra page 196. If the amount of a loss was uncertain when the estate tax return was filed, can it be claimed on an amended return when finally liquidated? Must a loss, to be deducted under §2054, occur before the estate tax return is due?

SECTION D. CHARITABLE BEQUESTS: §2055

MERCHANTS NATIONAL BANK v. COMMISSIONER

320 U.S. 256 (1943)

MR. JUSTICE RUTLEDGE delivered the opinion of the Court.

Ozro M. Field died in Massachusetts in 1936, leaving a gross estate of some $366,000. In his will he provided, after certain minor bequests, that the residue of his estate be held in trust, the income to go to his wife for life, and on her death all but $100,000 of the principal [1] to go "free and discharged of this trust" to certain named charities. Under the trust set up by the will, the trustee, petitioner here, was authorized to invade the corpus "at such time or times as my said Trustee shall in its sole discretion deem wise and proper for the comfort, support, maintenance, and/or happiness of my said wife, and it is my wish and will that in the exercise of its discretion with reference to such payments from the principal of the trust fund to my said wife, May L. Field, my said Trustee shall exercise its discretion with liberality to my said wife, and consider her welfare, comfort and happiness prior to claims of residuary beneficiaries under this trust."

[Under what is now §2055, the executor deducted as charitable bequests the value of the remainder interest in the trust, without making any allowance for the trustee's power to invade the principal for the benefit of the widow. The deduction was disallowed by the Commissioner, the executor filed a petition in the Tax Court and won, the Court of Appeals for the First Circuit reversed, and the Supreme Court granted certiorari.]

There is no question that the remaindermen here were charities. The case, at least under [§2055], turns on whether the bequests to the charities have, as of the testator's death, a "presently ascertainable" value or, put another way, on whether, as of that time, the extent to which the widow would divert the corpus from the charities could be measured accurately.

Although Congress, in permitting estate tax deductions for charitable bequests, used the language of outright transfer, it apparently envisaged deductions in some circumstances where contingencies, not resolved at the testator's death, create the possibility that only a calculable portion of the bequest may reach ultimately its charitable destination.[2] The Treasury has long accommodated the administration of the section to the narrow leeway thus allowed to charitable donors who wish to combine some private benefaction with their charitable gifts. The limit of permissible contingencies has been blocked out in a more convenient administrative form in Treasury Regulations which provide that, where a trust is created for both charitable and private purposes the charitable bequest, to be deductible, must have, at the testator's death, a value "presently ascertainable,

[1] The $100,000 was to remain in trust, the income to go in equal shares to his three adopted children and a niece of his wife, and on the death of the last of these beneficiaries the corpus was also to go to the named charities.

[2] E.g., the not unusual case of a bequest of income for life intervening between the testator and the charity, requiring computation, with the aid of reliable actuarial techniques and data, of present value from future worth.

and hence severable from the interest in favor of the private use," and further, to the extent that there is a power in a private donee or trustee to divert the property from the charity, "deduction will be limited to that portion, if any, of the property or fund which is exempt from an exercise of such power." * These Regulations are appropriate implementations of [§2055], and, having been in effect under successive reenactments of that provision, define the framework of the inquiry in cases of this sort. . . .

Whatever may be said with respect to computing the present value of the bequest of the testator who dilutes his charity only to the extent of first affording specific private legatees the usufruct of his property for a fixed period, a different problem is presented by the testator who, preferring to *insure* the comfort and happiness of his private legatees, hedges his philanthropy, and permits invasion of the corpus for their benefit. At the very least a possibility that part of the principal will be used is then created, and the present value of the remainder which the charity will receive becomes less readily ascertainable. Not infrequently the standards by which the extent of permissible diversion of corpus is to be measured embrace factors which cannot be accounted for accurately by reliable statistical data and techniques. Since, therefore, neither the amount which the private beneficiary will use nor the present value of the gift can be computed, deduction is not permitted. Cf. Humes v. United States, 276 U.S. 487.

For a deduction under [§2055] to be allowed, Congress and the Treasury require that a highly reliable appraisal of the amount the charity will receive be available, and made, at the death of the testator. Rough guesses, approximations, or even the relatively accurate valuations on which the market place might be willing to act are not sufficient. Cf. Humes v. United States, 276 U.S. 487, 494. Only where the conditions on which the extent of invasion of the corpus depends are fixed by reference to some readily ascertainable and reliably predictable facts do the amount which will be diverted from the charity and the present value of the bequest become adequately measurable. And, in these cases, the taxpayer has the burden of establishing that the amounts which will either be spent by the private beneficiary or reach the charity are thus accurately calculable. . . .

In this case the taxpayer could not sustain that burden. Decedent's will permitted invasion of the corpus of the trust for "the comfort, support, maintenance and/or happiness of my wife." It enjoined the trustee to be liberal in the matter, and to consider her "welfare, comfort and happiness prior to the claims of residuary beneficiaries," i.e., the charities.

Under this will the extent to which the principal might be used was not restricted by a fixed standard based on the widow's prior way of life. Compare Ithaca Trust Co. v. United States, 279 U.S. 151.† Here, for example, her "happi-

* The requirement that the value of the charitable bequest be "presently ascertainable" and "severable" from the noncharitable interest is carried forward by §20.2055-2(a) of the current regulations. The provision relating to bequests subject to diversion has been eliminated, but see §20.2055-2(b). — Ed.

† In the *Ithaca Trust Co.* case, the value of the remainder interest in a trust was allowed as a charitable bequest, although the decedent's widow had (in addition to a life interest in the income) the right to use principal to such extent as "may be necessary to suitably maintain her in as much comfort as she now enjoys." The court said: "The standard was fixed in fact and capable of being stated in definite terms of money. It was not left to the widow's discretion. The income of the estate at the death of the testator, and even after debts and specific legacies had been paid, was more than sufficient to maintain the widow as required. There was no uncertainty appreciably greater than the general uncertainty that attends human affairs." The court also held that in valuing the charitable bequest, allowance had to be made for the life interest of the widow computed on an actuarial basis as of the date of the decedent's death although she had died before the estate tax return was due. — Ed.

ness" was among the factors to be considered by the trustee. The sums which her happiness might require to be expended are of course affected by the fact that the trust income was not insubstantial and that she was sixty-seven years old with substantial independent means and no dependent children.[3] And the laws of Massachusetts may restrict the exercise of the trustee's discretion somewhat more narrowly than a liberal reading of the will would suggest, although that is doubtful. . . . Indeed one might well "guess, or gamble . . . , or even insure against" the principal being expended here. Cf. Humes v. United States, supra. But Congress has required a more reliable measure of possible expenditures and present value than is now available for computing what the charity will receive. The salient fact is that the purposes for which the widow could, and might wish to have the funds spent do not lend themselves to reliable prediction.[4] This is not a "standard fixed in fact and capable of being stated in definite terms of money." Cf. Ithaca Trust Co. v. United States, supra. Introducing the element of the widow's happiness and instructing the trustee to exercise its discretion with liberality to make her wishes prior to the claims of residuary beneficiaries brought into the calculation elements of speculation too large to be overcome, notwithstanding the widow's previous mode of life was modest and her own resources substantial. We conclude that the commissioner properly disallowed the deduction for estate tax purposes. . . .

Accordingly, the decision of the Court of Appeals is affirmed.

MR. JUSTICE DOUGLAS, with whom MR. JUSTICE JACKSON concurs, dissenting:

The Tax Court applied the correct rule of law in determining whether the gifts to charity were so uncertain as to disallow their deduction. That rule is that the deduction may be made if on the facts presented the amount of the charitable gifts are affected by "no uncertainty appreciably greater than the general uncertainty that attends human affairs." Ithaca Trust Co. v. United States, 279 U.S. 151, 154. In that event the standard fixed by the will is "capable of being stated in definite terms of money." Id., p. 154. The mere possibility of invasion of the corpus is not enough to defeat the deduction. The Tax Court applied that test to these facts. 45 B.T.A. 270, 273-274. Where its findings are supported by substantial evidence they are conclusive. We may modify or reverse such a decision only if it is "not in accordance with law." [§7482(c)(1).] See Wilmington Trust Co. v. Helvering, 316 U.S. 164, 168. The discretion to pay to the wife such principal amounts as the trustee deems proper for her "happiness" introduces of course an element of uncertainty beyond that which existed

3 The Board of Tax Appeals found that decedent had adopted three children — two girls and a boy — before his marriage to the present Mrs. Field. She never adopted the children. The two girls were married to husbands fully able to support them, and the boy was nearly twenty-one at the testator's death.

Immediately after decedent's death the widow owned income-producing property worth about $104,000. Her total income from her own property and the trust, and the amounts she has actually expended have been as follows:

Period	*Income*	*Expenditures*
1936 (7 months)	$10,735.35	$ 1,853.99
1937	24,738.57	10,357.91
1938	17,480.85	11,055.91
1939	17,448.23	12,024.92
1940	16,959.66	13,389.31
	$87,362.66	$48,682.04

4 E.g., the Board found that since her husband's death, Mrs. Field purchased two automobiles and a fur coat, took two pleasure trips, gave financial assistance to a niece, helped send a grand nephew through medical school, and purchased a fur coat for one of her husband's daughters.

in the *Ithaca Trust Co.* case. There the trustee only had authority to withdraw from the principal and pay to the wife a sum "necessary to suitably maintain her in as much comfort as she now enjoys." But the frugality and conservatism of this New England corporate trustee, the habits and temperament of this sixty-seven year old lady, her scale of living, the nature of the investments — these facts might well make certain what on the fact of the will might appear quite uncertain. We should let that factual determination of the Tax Court stand, even though we would decide differently were we the triers of fact.

NOTE

1. *Later cases re charitable remainders subject to invasion.* Several years later, this issue was before the Supreme Court again. In Henslee v. Union Planters Nat. Bank & Trust Co., 335 U.S. 595 (1949), a deduction was denied under these circumstances: the decedent's will provided that his gross estate of about $500,000 was to be held in trust for his mother, aged 85, to pay her $9000 per year for life, with the remainder (after certain legacies) to go to charities. The trustees could also pay the decedent's mother any part of the estate for her "pleasure, comfort and welfare." The estate was earning a net income of about $15,000 at the time of the decedent's death, and his mother, a woman "of moderate needs and without dependents," had investments of her own worth about $100,000. The Court held:

> We do not overlook the unlikelihood that a woman of the mother's age and circumstances would abandon her customary frugality and squander her son's wealth. But, though there may have been little chance of that extravagance which would waste a part or consume the whole of the charitable interest, that chance remained. What common experience might regard as remote in the generality of cases may nonetheless be beyond the realm of precise prediction in the single instance. The contingency which would have diminished or destroyed the charitable interest here considered might well have been insured against, but such an arithmetic generalization of experience would not have made this charitable interest "presently ascertainable." [335 U.S. at 599.]

Justices Douglas and Jackson dissented on the grounds stated in their dissent in the *Merchants Nat. Bank* case. Mr. Justice Frankfurter wrote:

> Wisdom too often never comes, and so one ought not to reject it merely because it comes late. Since I now realize that I should have joined the dissenters in the *Merchants Nat. Bank* case, 320 U.S. 256, I shall not compound error by pushing that decision still farther. I would affirm the judgment, substantially for the reasons given below. [335 U.S. at 600.]

The lower courts have had a hard time finding their way between the *Ithaca Trust Co.* case and the *Merchants Nat. Bank* case. For a summary of the decisions, see Kline v. United States, 202 F. Supp. 849 (N.D.W. Va. 1962); and see also the "ascertainable standard" cases, supra page 1157. In Blodget v. Delaney, 201 F.2d 589, 594-595 (1st Cir. 1953), Judge Magruder commented:

> If there is a "clear Congressional policy not to benefit the national revenue at the expense of charitable institutions," it seems that the decided cases have drawn an unfortunate line in denying a charitable deduction wherever the power to invade corpus is conferred in terms embracing "factors which cannot be accounted for accurately by reliable statistical data and techniques," 320 U.S. at page 261, even though on the existing facts and circumstances one might conclude to a moral certainty that the power would never be exercised and that the unimpaired remainder would go to the charity upon the death of the life tenant. . . . Instead of having to split hairs between "comfort and welfare" on the one hand and "comfort, support, maintenance, and/or happiness" on the other, it might seem more logical to adopt either of two alternatives: (1) To deny the charitable deduction unless the testator has

given an indefeasible remainder to charity upon the death of the life tenant, or (2) to allow the deduction in full wherever it is properly found as a fact upon consideration of all the circumstances that the chance of invasion of the corpus is negligible, however broadly or narrowly the power to invade corpus may be expressed in the will.

Would it be feasible to hold the disputed deduction in abeyance until the charitable remainder falls in, and allow it at that time?

2. *Conditional charitable bequests.* In Commissioner v. Sternberger's Estate, 348 U.S. 187 (1955), the Supreme Court had to pass on the deductibility of a bequest to charities that would take effect only if the decedent's daughter died without descendants surviving her and her mother. At the time of the decedent's death, his daughter was divorced, had not remarried, and had no children. Before the Tax Court, the decedent's executor introduced actuarial tables to establish the probability of the daughter's remarrying and having a child. On the basis of this evidence, the Tax Court allowed a deduction of about $180,000, representing the value at the time of the decedent's death of a conditional bequest of about one half of a $2,000,000 estate. The Court of Appeals for the Second Circuit affirmed. The Supreme Court reversed, resting primarily on Regs. §20.-2055-2(b), providing in part:

> If, as of the date of a decedent's death, a transfer for charitable purposes is dependent upon the performance of some act or the happening of a precedent event in order that it might become effective, no deduction is allowable unless the possibility that the charitable transfer will not become effective is so remote as to be negligible. [348 U.S. at 193.]

The Court also argued that the actuarial tables were misleading because they did not, and presumably could not, reflect the daughter's pecuniary incentive, created by the terms of the trust itself, to remarry and have children. To the executor's argument that Regs. §20.2055-2(a) provides for a deduction of the actuarial value of a remainder bequeathed to charity, the Court answered that this provision of the regulations is restricted to "deferred, but assured, bequests." It explained the *Ithaca Trust Co.* case as follows: "Where the amount [of the conditional bequest to charity] has been determinable, the deduction has . . . been allowed where the designated charity has been sure to benefit from it." Justices Reed and Douglas dissented.

United States v. Dean, 224 F.2d 26 (1st Cir. 1955), concerned the deductibility of a charitable bequest that would take effect if a woman of 82 predeceased two women aged 67 and 68. An actuarial computation showed that the charity had ten chances in eleven to take. The court held that the *Sternberger* case's rejection of actuarial tables was not controlling on these facts, since

> . . . here the chance that charity will take does not depend upon the probability of anyone having issue, a matter involving an element of volition. In this case the chance that charity will benefit depends entirely upon the relative longevity of three persons, a matter unaffected by volition or personal inducement, for it would be preposterous to assume that either [of the two younger women] would choose to commit suicide in order to defeat the decedent's bequest to charity. [224 F.2d at 28.]

But the deduction was denied on the ground that under the *Sternberger* case, a contingent bequest was to be allowed in full only if the chance of its not taking was so remote as to be negligible, but disallowed otherwise. See also Rev. Rul. 59-143, 1959-1 C.B. 247 (charitable bequest contingent on death of two women, aged 55 and 59, without issue; held, statistical probability of issue so remote as to be "negligible" so deduction is allowable); Bankers Trust Co. v. United States, 191 F. Supp. 792 (S.D.N.Y. 1961), aff'd per curiam, 299 F.2d 936 (2d Cir. 1962) (contra as to woman of 47, especially in view of "factor of individual volition").

Suppose the life beneficiary of a trust, the remainder of which will go to a charity, is to receive an annuity that, if he greatly outlives his life expectancy, will exhaust both the income and the principal of the trust. Will the actuarial value of the charitable

bequest be deductible? Does the annuitant have an incentive to live carefully? According to an old saw, "Annuitants never die; pensioners live forever."

What is the effect of a charitable bequest that is conditioned upon specified action by the recipient, for example, to Yale, to establish the Josef Djugashvilli Professorship of Political Economy? See Churchill v. United States, 68 F. Supp. (E.D. Wis. 1946) (bequest to local and state government of farm, to be used as public park, with gift over to an individual legatee if the property was not accepted for such use or if it ceased to be so used; held, although property was accepted for park use 4 years after decedent's death, the possibility of non-acceptance was more than negligible, so no deduction allowed; in a dictum, the court suggested that prompt acceptance would have justified a deduction because later divestment for failure to continue the public use would have been a negligible possibility). See Perry v. United States, supra page 75, for another contingent gift to charity.

3. *Disclaimer of intervening noncharitable bequest.* The parenthetical clause of §2055(a) provides a method by which an intervening noncharitable bequest, power of invasion, etc. may be relinquished in order to save the charitable deduction. As to a purported disclaimer of rights under a spendthrift trust, see Schoonmaker's Estate v. Commissioner, 6 T.C. 404 (1946). The final sentence of §2055(a) was added in 1954 to insure that a charitable deduction would be allowed if the intervening right to invade corpus for a noncharitable purpose terminated by reason of the beneficiary's death before the estate tax return was due. The provision was explained at 100 Cong. Rec. 9496 (1954) as especially intended to protect the charitable deduction where the beneficiary was in such bad health when the decedent died that he could not execute the disclaimer authorized by the parenthetical clause of §2055(a).

The decedent executed a will by which he made certain charitable bequests, and died within 30 days thereafter. The law of his state (Pennsylvania) provided that bequests for charitable or religious uses made by will within 30 days of death "shall be void and go to the residuary legatee or devisee, heirs or next of kin, according to law." The residuary legatees waived any objection to a distribution of the estate according to the terms of the will, however, and the probate court ordered distribution to be made accordingly. The Tax Court held that because of the state statute the attempted gift to charities were void so that there were no "bequests, legacies, devises, or transfers" *from the decedent,* and that what the charities received was a gift from the residuary legatees. The "disclaimers" were held to be irrelevant, on the ground that the parenthetical clause of §2055(a) permits a deduction only if an interest "falls into" a bequest, etc., as a result of the disclaimer. The court distinguished two similar cases allowing the deduction on the ground that the state statutes there involved made the charitable bequests "voidable rather than void." (In fact, one statute used the term "void" and the other the term "invalid.") Estate of Carey v. Commissioner, 9 T.C. 1047 (1947), aff'd without opinion sub nom. Marine Nat. Bank v. Commissioner, 168 F.2d 400 (3d Cir. 1948).

4. *Fulfillment of condition after decedent's death as validating a contingent bequest.* If the daughter in *Sternberger's Estate* had died without issue shortly after the decedent's death and thus insured that the charity would take the remainder interest, would the rationale of the *Gowetz* case, supra page 1276, have justified a charitable deduction? The Regulations state that a deduction is allowable only if "as of the date of a decedent's death" the possibility that the charity will not take the bequest is so remote as to be negligible. Regs. §20.2055-2(b). Is there a difference between §2053 and §2055 in their tolerance for evidence based on post-death events? Does the last sentence of §2055(a) (bequest deductible if power to consume, etc. terminates before estate tax return is due, without having been exercised) give rise to a negative inference that no other events occurring after the death of the decedent will serve to qualify a charitable bequest for a deduction?

5. *Computation of amount of charitable bequest.* Section 2055(c) provides that if any death taxes are payable out of the charitable bequest, the deduction is limited to the net amount receivable by the charity. This provision overrules Edwards v. Slocum, 264 U.S. 61 (1924), holding under prior law that the gross amount of a residuary bequest to charities could be deducted even though they would receive the residue less federal and

state death taxes. In Harrison v. Northern Trust Co., 317 U.S. 476 (1943), the taxpayer contended — after the statute had been amended — for a similar result on the ground that the federal estate tax was not "payable . . . out of" the residuary (charitable) bequest because under Illinois law it was a *charge* against the entire estate, though its ultimate *burden* was admittedly on the residue. The Court held that "Congress used the words 'payable out of' in the sense of 'diminished or reduced by' the payment of the tax." Since the taxes due depend on the size of the charitable deduction and vice versa, computation of the taxes payable in such cases requires trial and error or the use of algebraic formulas, details of which may be found in the loose-leaf tax services. See also Burstein and Stein, Computation of Estate Tax When Interdependent Deductions Are Present, 29 Taxes 455 (1951).

In Luehrmann's Estate v. Commissioner, 287 F.2d 10 (8th Cir. 1961), in which the executors elected to deduct administration expenses on the income tax return rather than on the estate tax return (supra p. 1272), the court held that if the corpus of the estate was in fact diminished by the expenses, the charitable deduction was limited to the amount actually payable to the charity. The Tax Court (33 T.C. 277) had held that even if the expenses were paid out of income, the estate could deduct only the bequest less the expenses, on the theory that the additional amount received by the charity was a contribution by the income beneficiary rather than the estate.

See Rev. Rul. 145, 1953-2 C.B. 273, involving a compromise agreement under which the decedent's second will was admitted to probate with the consent of a charity that was to have received a bequest under an earlier will; the Service ruled that the amount actually paid to the charity under the compromise was deductible, even though it exceeded the amount specified in the second will; DuMont's Estate v. Commissioner, 150 F.2d 691 (3d Cir. 1945) (amount paid to charity under compromise deductible under doctrine of Lyeth v. Hoey, supra p. 145).

Section 2053(d), enacted in 1956 but retroactive to January 1, 1954, is concerned with an intricate aspect of this already complicated area. Some states levy an inheritance tax on charitable bequests. If the state tax is paid out of the amount that would otherwise go to the charity, only the net amount qualifies as a charitable deduction under §2055(c); and if the resulting increase in federal estate tax must also be paid out of the bequest, the charity's share will be reduced still further. The executor may elect under §2053(d) to deduct the state inheritance tax in such a case, provided the resulting decrease in the federal estate tax will inure to the benefit of the charity. See Darlington's Estate v. Commissioner, 36 T.C. 599 (1961).

See Drye, Testamentary Gifts of Income to Charity, 13 Tax L. Rev. 49 (1957), discussing certain tax and other benefits that may result from making a charitable bequest in the form of income (e.g., a testamentary trust under which the income will go to charity for 5 years), rather than in the form of an outright bequest.

6. *Qualified charitable donees.* To qualify for the deduction, the charitable bequest must be to or for the use of an organization described in §2055(a). As pointed out supra page 175, the provisions for income, estate, and gift tax deductions for charitable contributions largely overlap in specifying the characteristics of qualifying organizations, but there are some unaccountable minor variations.

SECTION E. THE MARITAL DEDUCTION: §2056 *

UNITED STATES v. STAPF

375 U.S. 118 (1963)

MR. JUSTICE GOLDBERG delivered the opinion of the Court.

Respondents brought this suit against the Government in the District Court for the Northern District of Texas for a refund of estate taxes paid pursuant to an asserted deficiency. The Court of Appeals for the Fifth Circuit held that respondents were entitled to certain marital deductions under [§2056]. . . .

* For background, see pages 1110 et seq. supra.

Lowell H. Stapf died testate on July 29, 1953, a resident and domiciliary of Texas, a community property jurisdiction. At the time of his death he owned, in addition to his separate estate, a substantial amount of property in community with his wife. His will required that his widow elect either to retain her one-half interest in the community or to take under the will and allow its terms to govern the disposition of her community interest. If Mrs. Stapf were to elect to take under the will, she would be given, after specific bequests to others, one-third of the community property and one-third of her husband's separate estate. By accepting this bequest she would allow her one-half interest in the community to pass, in accordance with the will, into a trust for the benefit of the children. It was further provided that if she chose to take under the will the executors were to pay "all and not merely one-half" of the community debts and administration expenses.

The relevant facts and computations are not in dispute. The decedent's separate property was valued at $65,100 and the community property at $258,105. The only debts were community debts totalling $32,368. The administration expenses, including attorneys' fees, were $4,073. If Mrs. Stapf had not elected to take under the will, she would have retained her fully vested one-half interest in the community property ($129,052) which would have been charged with one-half of the community debts ($16,184) and 35% of the administration expenses ($1,426). Thus, as the parties agree, she would have received a net of $111,443.

In fact Mrs. Stapf elected to take under the will. She received, after specific bequests to others, one-third of the combined separate and community property, a devise valued at $106,268, which was $5,175 less than she would have received had she retained her community property and refused to take under the will.[1]

In computing the net taxable estate, the executors claimed a marital deduction under [§2056] of the Internal Revenue Code of [1954] for the full value of the one-third of decedent's separate estate ($22,367) which passed to his wife under the will. The executors also claimed a deduction for the entire $32,368 of community debts as "claims against the estate" under [§2053(a)(3)] and for the entire $4,073 of expenses as "administration expenses" under [§2053(a)(2)]. The Commissioner of Internal Revenue disallowed the marital deduction and the deductions for claims and administration insofar as these represented debts (50%) and expenses (35%) chargeable to the wife's one-half of the community. Respondents then instituted this suit for a tax refund. The District Court allowed the full marital deduction but disallowed the disputed claims and expenses. 189 F. Supp. 830. On cross-appeals the Court of Appeals, with one judge dissenting on all issues, held that each of the claimed deductions was allowable in full. 309 F.2d 592. For reasons stated below, we hold that the Commissioner was correct and that none of the disputed deductions is allowable.

I. The Marital Deduction

By electing to take under the will, Mrs. Stapf, in effect, agreed to accept the property devised to her and, in turn, to surrender property of greater value to the

[1] The parties agree that the net effect of taking under the will may be computed by another method. As explained by the Court of Appeals, "Computed differently but with the same result, the widow retained a one-third interest out of the one-half of the community owned by her, thereby transferring only a one-sixth interest under the election to take. Under this method of computation she transferred property having a valuation of $27,541.16 and received property being the one-third interest in the separate property of the husband and the one-half interest in the automobile of the aggregate value of the $22,366.66, making a net loss to her of $5,174.50." 309 F.2d 592, 594.

trust for the benefit of the children. This raises the question of whether a decedent's estate is allowed a marital deduction under [§2056(b)(4)(B)] where the bequest to the surviving spouse is on the condition that she convey property of equivalent or greater value to her children. The Government contends that, for purposes of a marital deduction, "the value of the interest passing to the wife is the value of the property given her less the value of the property she is required to give another as a condition to receiving it." On this view, since the widow had no net benefit from the exercise of her election, the estate would be entitled to no marital deduction. Respondents reject this net benefit approach and argue that the plain meaning of the statute makes detriment to the surviving spouse immaterial.

Section [2056(b)(4)] deals specifically with the question of valuation:

> (4) Valuation of Interest Passing to Surviving Spouse. — In determining for the purposes of [§2056(a)] the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section —
>
> . . .
>
> (B) where such interest or property is incumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such incumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

The disputed deduction turns upon the interpretation of (1) the introductory phrase "any obligation imposed by the decedent with respect to the passing of such interest," and (2) the concluding provision that "such . . . obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined."

The Court of Appeals, in allowing the claimed marital deduction, reasoned that since the valuation is to be "as if" a gift were being taxed, the legal analysis should be the same as if a husband had made an inter vivos gift to his wife on the condition that she give something to the children. In such a case, it was stated, the husband is taxable in the full amount for his gift. The detriment incurred by the wife would not ordinarily reduce the amount of the gift taxable to the husband, the original donor.[2] The court concluded:

> Within gift tax confines the community property of the widow passing under the will of the husband to others may not be "netted" against the devise to the widow, and thus testator, were the transfer inter vivos, would be liable for gift taxes on the full value of the devise. 309 F.2d 592, 598.

This conclusion, based on the alleged plain meaning of the final gift-amount clause of [§2056(b)(4)(B)], is not supported by a reading of the entire statutory provision. First, [§2056(a)] allows a marital deduction only for the decedent's gifts or bequests which pass "to his surviving spouse." In the present case the effect of the devise was not to distribute wealth to the surviving spouse, but instead to transmit, through the widow, a gift to the couple's children. The gift-to-the-surviving-spouse terminology reflects concern with the status of the actual recipient or donee of the gift. What the statute provides is a "marital deduction" — a deduction for gifts *to the surviving spouse* — not a deduction for gifts

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[2] See, e.g., Commissioner v. Wemyss [supra p. 1025]. There the Court stated that under the Revenue Act of 1932 mere detriment to the transferee did not constitute the requisite "consideration in money or money's worth" to the transferor so as to relieve him of gift tax liability. Respondents' reliance on this case ignores that it involved neither a determination of who was to be considered the beneficial donee nor a valuation of the gift received by such donee.

to the children or a deduction for gifts to privately selected beneficiaries. The appropriate reference, therefore, is not to the value of the gift moving from the deceased spouse but to the net value of the gift received by the surviving spouse.

Second, the introductory phrases of [§2056(b)(4)(B)] provide that the gift-amount determination is to be made "where such interest or property is incumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest. . . ." The Government, drawing upon the broad import of this language, argues: "An undertaking by the wife to convey property to a third person, upon which her receipt of property under the decedent's will is conditioned, is plainly an 'obligation imposed by the decedent with respect to the passing of such interest.'" Respondents contend that "incumbrance or obligation" refers only to "a payment to be made *out of* property passing to the surviving spouse." Respondents' narrow construction certainly is not compelled by a literal interpretation of the statutory language. Their construction would embrace only, for example, an obligation *on* the property passing whereas the statute speaks of an obligation "*with respect* to the passing" gift. Finally, to arrive at the real value of the gift "such . . . obligation shall be taken into account. . . ." In context we think this relates the gift-amount determination to the net economic interest received by the surviving spouse.

This interpretation is supported by authoritative declarations of congressional intent. The Senate Committee on Finance, in explaining the operation of the marital deduction, stated its understanding as follows:

> If the decedent bequeaths certain property to his surviving spouse *subject,* however, *to her agreement,* or a charge on the property, for payment of $1,000 to X, the value of the bequest (and, accordingly, the value of the interest passing to the surviving spouse) is the value, reduced by $1,000, of such property." S. Rep. No. 1013, 80th Cong., 2d Sess., Pt. 2, p. 6. (Emphasis added.)

The relevant Treasury Regulation is directly based upon, if not literally taken from, such expressions of legislative intent. Treas. Reg. [§20.2056(b)-4(b)]. The Regulation specifically includes an example of the kind of testamentary disposition involved in this case:

> A decedent bequeathed certain securities to his wife in lieu of her interest in property held by them as community property under the law of the State of their residence. The wife elected to relinquish her community property interest and to take the bequest. For the purpose of the marital deduction, the value of the bequest is to be reduced by the value of the community property interest relinquished by the wife.[3]

We conclude, therefore, that the governing principle, approved by Congress and embodied in the Treasury Regulation, must be that a marital deduction is allowable only to the extent that the property bequeathed to the surviving spouse exceeds in value the property such spouse is required to relinquish.

[3] The Regulation provides another relevant illustration "of property interests which passed from the decedent to his surviving spouse subject to the imposition of an obligation by the decedent: (1) A decedent devised a residence valued at $25,000 to his wife, with a direction that she pay $5,000 to his sister. For the purpose of the marital deduction, the value of the property interest passing to the wife is only $20,000."

See Lowndes and Kramer, Federal Estate and Gift Taxes (1962), §17.4: "[W]hat the Regulations are driving at seems to be this. If a decedent bequeaths property to his wife in lieu of her interest in community property, which is not part of his estate and which does not pass to her from him, it seems clear that the only thing which the surviving spouse actually receives from the decedent is the excess of the interest bequeathed to her over and above the value of her interest in the community property. Therefore, this should be the only amount which qualifies for the marital deduction. . . ."

Our conclusion concerning the congressionally intended result under [§2056] accords with the general purpose of Congress in creating the marital deduction. The 1948 tax amendments were intended to equalize the effect of the estate taxes in community property and common-law jurisdictions. Under a community property system, such as that in Texas, the spouse receives outright ownership of one-half of the community property and only the other one-half is included in the decedent's estate. To equalize the incidence of progressively scaled estate taxes and to adhere to the patterns of state law, the marital deduction permits a deceased spouse, subject to certain requirements, to transfer free of taxes one-half of the non-community property to the surviving spouse. Although applicable to separately held property in a community property state, the primary thrust of this is to extend to taxpayers in common-law States the advantages of "estate splitting" otherwise available only in community property States. The purpose, however, is only to permit a married couple's property to be taxed in two stages and not to allow a tax-exempt transfer of wealth into succeeding generations. Thus the marital deduction is generally restricted to the transfer of property interests that will be includible in the surviving spouse's gross estate. Respondents' construction of [§2056] would, nevertheless, permit one-half of a spouse's wealth to pass from one generation to another without being subject either to gift or estate taxes.[4] We do not believe that this result, squarely contrary to the concept of the marital deduction, can be justified by the language of [§2056]. Furthermore, since in a community property jurisdiction one-half of the community normally vests in the wife, approval of the claimed deduction would create an opportunity for tax reduction that, as a practical matter, would be more readily available to couples in community property jurisdictions than to couples in common-law jurisdictions. Such a result, again, would be unnecessarily inconsistent with a basic purpose of the statute.

Since in our opinion the plain meaning of [§2056] does not require the interpretation advanced by respondents, the statute must be construed to accord with the clearly expressed congressional purposes and the relevant Treasury Regulation. We conclude that, for estate tax purposes, the value of a conditional bequest to a widow should be the value of the property given to her less the value of the property she is required to give to another. In this case the value of the property transferred to Mrs. Stapf ($106,268) must be reduced by the value of the community property she was required to relinquish ($111,443). Since she received no net benefit, the estate is entitled to no marital deduction.

II. Claims Against the Estate and Administration Expenses

[Omitted.]

NOTE

References. On the question whether the marital deduction has achieved the equalization between community property and common law states for which it was enacted, see Anderson, The Marital Deduction and Equalization Under the Federal Estate and Gift

[4] The Court of Appeals recognized the effect of its decision: "Here estate taxes are due now on the property of the husband with the devise to the widow excluded. It is a part of the marital deduction or exclusion on which taxes are deferred to the estate of the widow to be assessed on so much of it as survives on another day. The net of the transfer by the widow became subject to gift taxes at the time of the transfer. The property transferred by the widow will, to the extent of an amount equal to the devise to her, escape both gift and estate taxes." 309 F.2d 592, 598. For an illustration of the tax effects of the decision, see the dissent of Judge Wisdom. 309 F.2d, at 608-609.

Taxes Between Common Law and Community Property States, 54 Mich. L. Rev. 1087 (1956); Surrey, Federal Taxation of the Family — The Revenue Act of 1948, 61 Harv. L. Rev. 1097, 1117-1159 (1948); De Wind, The Approaching Crisis in Federal Estate and Gift Taxation, 38 Calif. L. Rev. 79, 86-91 (1950).

VERMILYA'S ESTATE v. COMMISSIONER

41 T.C. 226 (1963)

FAY, Judge: The respondent determined a deficiency of $1,265.44 in the estate tax of the petitioner. The only issue for decision is whether the petitioner is entitled to the estate tax marital deduction with respect to the property passing from the decedent to his wife under the decedent's will.

All of the facts are stipulated and are found as stipulated.

The petitioner, the estate of James Mead Vermilya, by its executor, George H. Vermilya, filed its Federal estate tax return with the district director of internal revenue, St. Paul, Minnesota.

The decedent during his lifetime was married to Anna Vermilya. On August 8, 1957, decedent and Anna executed a joint and reciprocal will which provided as follows:

JOINT LAST WILL AND TESTAMENT

I, Mead Vermilya, and I, Anna Vermilya, husband and wife, and each of us, and both of us, being of sound mind and memory, and realizing the uncertainty of life, and the certainty of death, and wishing to direct how our property shall be distributed on the death of each of us, and both of us, do hereby make, publish and declare this to be our Last Will and Testament, and do hereby revoke all former wills and codicils by us made.

ARTICLE I

It is the will of each of us, and of both of us, that all our just debts and funeral expenses, and costs of administration be paid as soon after our death as practical.

ARTICLE II

It is the will and desire of each of us, and the mutual wish and desire of both of us that on the death of either of us all the property of the deceased party, whether real, personal or mixed shall become the property of the surviving party in fee simple and absolute.

In furtherance of this intention, I, Mead Vermilya, and I, Anna Vermilya, and each of us for ourselves do hereby give, devise and bequeath to the survivor of us all of the property, both real and personal, of which I may die seized, possessed or entitled, to have and to hold in fee simple and absolute.

ARTICLE III

After the death of both of us, and of the survivor of us, we give, devise and bequeath to Kenneth Majerus, an undivided one-half interest in and to our home farm, being that parcel of land in the County of Olmsted, and State of Minnesota, described as follows. . . .

[Articles IV-VII, making similar bequests, omitted.]

ARTICLE VIII

After the death of both of us and of the survivor of us, we direct that our executor liquidate and convert into cash all the assets remaining after the payment of the specific legacies hereinbefore set forth in Articles I to VII inclusive, and that of the sum so realized, we give, devise and bequeath as follows:

[Fractional shares to various relatives omitted.]

On February 10, 1959, with the will still in effect, James died. On February 21, 1959, Anna petitioned the Probate Court of Wabasha County, Minnesota, to admit this will to probate. After a hearing, the will was admitted to probate on March 30, 1959. George H. Vermilya, who was appointed executor in the will, was issued letter testamentary authorizing him to act as executor on April 6, 1959.

At the time of his death, James owned the following property, valued as of that time:

1. [Land]	$46,000.00
2. 65 shares of common stock of Vermilya Brothers, Incorporated	20,930.00
3. Other stocks and bonds	767.00
4. Jointly owned property	7,304.88
5. Miscellaneous personal property	13,732.00
Total	$88,733.88

The estate incurred and claimed deductible funeral and administrative expenses in the amount of $1,720.49.

On July 11, 1959, the executor filed a final accounting for the estate. After a hearing was held on this final accounting, an order of distribution was entered by the Probate Court of Wabasha County on September 23, 1959, vesting the entire estate in Anna in fee simple.

On its estate tax return the estate claimed a marital deduction in the amount of $43,506.69, which was one-half of the adjusted gross estate. The respondent determined that the estate was not entitled to a marital deduction for the property passing to Anna under the will, and accordingly disallowed the deduction claimed except for the amount of $7,304.88, which was the value of joint property passing to Anna.

The respondent contends, on two separate grounds, that the decedent's wife received only a "terminable interest" in the property she received under the decedent's will, and thus the petitioner is not entitled to claim the marital deduction with respect to it. This contention is based on section 2056(b)(1). . . .

As the first ground for the respondent's contention, he urges that the decedent's will grants only a life estate to the surviving spouse in the property passing under it.

In determining what estate was created in the surviving spouse by the will, we must look to state law, Morgan v. Commissioner, 309 U.S. 78 (1940). It is true that Minnesota, in which the decedent was domiciled at his death, applies the general rule in construing wills that the intent of the testator governs. In re Freeman's Estate, 151 Minn. 446, 187 N.W. 411 (1922). Furthermore, the intent of the testator, as determined by a reading of the entire will, may control in spite of specific language in the will indicating a contrary result. In re Quinlan's Estate, 233 Minn. 35, 45 N.W.2d 807 (1951). However, Minnesota cases lead us to conclude that the Minnesota courts would hold the will granted a fee simple absolute title to the surviving spouse. In re Wadsworth's Estate, 176 Minn. 445, 223 N.W. 783 (1929); In re Hasey's Estate, 192 Minn. 582, 257 N.W. 498 (1934). Since we reach the same conclusion as the Minnesota Probate Court, we need not consider the effect of that court's decree of distribution.

As a second ground for the respondent's contention, he urges that the joint and reciprocal will evidences a contract between the decedent and his spouse that each would leave his property on death in the manner provided in the will. Thus, he says, all property which the surviving spouse received from the decedent was received subject to a contract duty to will it in a specific way. Therefore, he would conclude that all of the interests in property received by the surviving spouse under the will were "terminable interests" within the meaning of section 2056(b)(1)

of the Code and, thus, not qualified for the marital deduction. He bases the latter conclusion on section 20.2056(e)-2(a), Estate Tax Regs., which provides:

> The deduction may not be taken with respect to a property interest which passed to such spouse merely as trustee, or subject to a binding agreement by the spouse to dispose of the interest in favor of a third person. . . .

The States are divided on the question whether the existence of a contract can be inferred from a joint and reciprocal will alone. We find no Minnesota case settling the matter in that jurisdiction.

Contracts to dispose of property in a certain way are recognized as lawful in Minnesota. Mosloski v. Gamble, 191 Minn. 170, 253 N.W. 378 (1934). The case of Mosloski v. Gamble, supra, explains the effect of these contracts under Minnesota law. Where a promisor under such a contract makes a will carrying out the terms of the contract, the will remains revocable. Whether the will is revoked or not, the property owned by the promisor at his death will pass through his probate estate. If no effective will is left carrying out the terms of the contract, the beneficiary under the contract may bring a collateral action in an equity court and have a constructive trust impressed upon the property which is subject to the contract.

If, as the respondent contends, the joint will here is contractual as well as testamentary, then the terms of the contract would be found in the provisions of the will. In the will each spouse leaves everything absolutely to the surviving spouse. By the remaining testamentary provisions the last spouse to die leaves all property owned at death to certain collateral relatives of each testator. Thus, if the will evidences an agreement, that agreement was as follows: That in return for the reciprocal gifts and for each other's promise each spouse agreed to leave his property, at death, in the manner provided in the joint will. This agreement would apply to two classes of property. It would apply on the one hand to specific items of property referred to in the joint will, and on the other hand, to all other property of the last spouse to die, whether acquired from the other spouse or not. Thus, the agreement was to make certain specific devises and certain general devises of all other property owned at death. We point out this dichotomy because, as we shall show, promises to leave specific property and promises to leave all property owned at death are treated differently.

Where a contract is made to devise specific property, a conveyance of that property by the promisor during his lifetime is a breach of contract. . . . If the conveyance is to a bona fide purchaser who takes legal title for value and without notice of the contract, the conveyance cannot be set aside. . . . If, however, the grantee of such a conveyance did not give value or had notice of the contract at the time of the grant, the conveyance may be set aside. . . .

The situation is different in the case of a contract to devise some general class of property such as "all property owned at death." Under such a contract, the promisor may deal with the property involved as he wishes and may even make gifts if they are reasonable in amount and not in fraud of the rights of the contract beneficiary. . . .

Having considered the rights conferred on the contract beneficiary by each type of contract, we must now determine whether property received subject to such contracts should be considered as a "terminable interest" under the language of section 2056(b) of the Internal Revenue Code of 1954.

The first requirement of a "terminable interest" under section 2056(b) is that "an interest in such property passes or has passed (for less than an adequate and full consideration in money or money's worth) from the decedent to any person other than such surviving spouse (or the estate of such spouse)." Under a con-

tract to devise specific property, the rights of the contract beneficiary might be considered sufficiently extensive to justify a conclusion that the beneficiary has received an interest in the property at the time the contract is made. We believe that it is to property subject to this type of contract that the provision of the Estate Tax Regulations (section 20.2056(e)-2(a), supra), upon which the respondent relies, refers.

However, in the case of a contract to leave all property owned at death, it cannot be said that any interest in property is received by the beneficiary upon the making of the contract. This type of contract does not apply to any specific property. Such property as the promisor has at any time during his lifetime may be used up or conveyed away by the time the promisor is ultimately required to perform. A contract of this kind may operate actually only on property acquired by the promisor after he has made the contract, as, for example, in the case where the promisor had no property at the time the contract was made. Therefore, during the lifetime of the promisor the beneficiary cannot be considered as having an interest in the property. . . . Thus, if a decedent leaves property to his spouse, that property is not disqualified for the marital deduction as a "terminable interest" merely because it would, if held until the death of the second spouse, be subject to a contract to leave all property owned at death in a certain manner.

In applying these rules to the circumstances before us, we find that provision was made for a specific devise of a one-half interest in certain lands. It appears that at the death of the decedent he owned other land in addition to that mentioned in the will. However, even if half of the value of all of the land he owned at death was excluded from the marital deduction, there would still remain a sufficient deduction to eliminate any estate tax upon the estate. . . .

For the same reason, it is unnecessary for us to decide whether the specific gifts in the will of shares of stock in Vermilya Brothers, Incorporated, were intended to constitute specific devises or general devises. Even if the value of the 32½ shares of stock mentioned in the will was to be excluded from the marital deduction, no tax would result.

No other property is specifically mentioned in the will. Thus, all other property received by the decedent's spouse could be subject only to a general promise to leave all the property owned by her at her death in the manner provided in the will. We hold that such other property qualifies for the marital deduction.

Finally, it might be pointed out that our case here differs from Estate of Emmet Awtry, 22 T.C. 91 (1954), reversed 221 F.2d 749 (C.A. 8, 1955). In that case the will specifically granted a life estate only to the surviving spouse, whereas here the will grants a fee simple estate. This case also differs from Estate of Gust Marion Peterson, 23 T.C. 1020 (1955), reversed per curiam 229 F.2d 741 (C.A. 8, 1955). In the *Peterson* case we held that the will granted a life estate only to the surviving spouse under the laws of Nebraska. Here we have a case arising in Minnesota, and under Minnesota law it appears clear that the surviving spouse would be held to receive a fee simple estate. Lastly, the interest given the surviving spouse here differs from the life estate with power of invasion with which we dealt in Estate of Francis F. Field, 40 T.C. 802 (1963). There we held a life estate with power of invasion disqualified for the marital deduction because the surviving spouse could not appoint to herself or her estate. Here the surviving spouse received the full fee simple title to the property involved, and, if she owns it at her death, it will pass through her probate estate.

Reviewed by the Court.

Decision will be entered for the petitioner.

WITHEY, J., concurring: I concur in the result herein in view of the wording of Article II of the will. In the first paragraph it is unequivocally stated that the

intention of the mutual testators is that all property of the deceased testator "shall become the property of the surviving party in fee simple and absolute" and the bequest contained in the second paragraph of Article II to the effect that all such property shall go to the survivor "to have and to hold in fee simple and absolute" is in pursuance of that clearly stated intention. Differentiation in this opinion between property bequeathed generally and property which is devised specifically is therefore, in my view, unwarranted. With an intention so clearly stated and so clearly carried out I cannot conclude but what, should it have been necessary for the taxpayer herein or should she have merely desired to use all of the property passing to her from her deceased husband under their mutual will a Minnesota Court would not have prevented her from doing so.

BRUCE, FISHER, and MULRONEY, JJ. agree with this concurring opinion.

NOTE

1. *Joint and reciprocal wills.* In *Vermilya's Estate,* the court held that the widow's interest in the property bequeathed to her by her husband was not "terminable" within the meaning of §2056(b). Did the court also hold, by implication, that the limitation of §2056(b)(4), regarding the effect of encumbrances on the value of the surviving spouse's interest, was not applicable? Does the *Stapf* case, supra page 1286, require any revision in the result or reasoning in *Vermilya's Estate?*

In view of the restrictions (described in *Vermilya's Estate*) imposed by a joint and reciprocal will on the survivor's power to dispose of specific property owned by him or acquired by inheritance from his spouse, is such property includible in his gross estate? See Olson v. Reisimer, 271 F.2d 623 (7th Cir. 1959).

2. *Reference.* Comment, Joint and Mutual Wills and the Martial Deduction, 44 Marq. L. Rev. 209 (1960); Comment, The Mysterious Non-Terminable Terminable Interest: Reciprocal Wills, Inter-Spousal Contracts, Joint Tenancies, and the Federal Estate Tax Marital Deduction, 55 Nw. U.L. Rev. 727 (1961).

PIATT v. GRAY

321 F.2d 79 (6th Cir. 1963)

Before MILLER, Circuit Judge, and MCNAMEE and BOYD, District Judges.

MCNAMEE, District Judge.

This appeal challenges the correctness of the judgment of the District Court in disallowing a marital deduction for an interest passing under the will of Thomas Carr Piatt to his widow, Jane G. Piatt. Thomas Carr Piatt died at his residence in Fayette County, Kentucky on November 14, 1953. His will was admitted to probate on November 23, 1953. Item III of the will gives rise to this controversy, and, in pertinent part, provides:

> All of the rest and residue of my personal estate consisting of my personal property of any nature or description whatsoever after the payment of debts and these specific bequests above set out, I give and bequeath the same to my beloved wife, Jane, for and during her natural life. She shall have the power, right and authority whenever, in her opinion, it shall be necesary for her maintenance, comfort or well-being to expend all or any part of the principal of my said personal property without being required to account therefor, and she shall have the further right, power and authority to sell, lease, encumber or otherwise dispose of any and all items of personal property belonging to me and to give any purchaser a good fee simple title thereto.
>
> Upon the death of my beloved wife, Jane, the remainder of my personal estate I give and bequeath to my sister, Nancy Piatt Young, in trust for her life.

with further provision that upon the death of Nancy Piatt Young the property shall pass to her children.

The District Court's disallowance of the claim for marital deduction was on the ground that the surviving spouse lacked the power to make an independent testamentary disposition of the unconsumed portion of the principal of the estate withdrawn by her. The appellee, who of course prevailed in the court below, agrees with the result reached by the District Court but disagrees with that court's determination that to qualify for a marital deduction the widow must have the power to make a testamentary disposition of the property. Appellee asserts, however, that the district court's decision is sustainable on other grounds. It is fundamental that — "[I]f the decision below is correct, it must be affirmed, although the lower court relied upon a wrong ground or gave a wrong reason." Helvering v. Gowran, 302 U.S. 238, 245, and cases cited therein.

We are called upon to decide (A) whether the terms of Item III of the testator's will meet the requirements of [§2056] so as to warrant the allowance of the marital deduction; and (B) to determine the specific legal interest or right created by Item III of the will under the law of Kentucky.

(A)

In the opinion of the appellants the bequest to the widow of the life estate in the testator's personal property with the concomitant powers therein conferred is the equivalent of a life estate with the general power of appointment under [§2056-(b)(5)], as amended by Section 93 of the Technical Amendments Act of 1958.* In support of the foregoing contention appellants rely heavily on the legislative history of Section 93, particularly on House Report No. 1027 of the House Committee on Ways and Means which accompanied H.R. 8881. Appellants place special emphasis on the following language of the Report:

> For example, *if the surviving spouse has, in addition to a life interest, the unrestricted right, in her sole discretion, to invade and use the property generally for her comfort, happiness and well being, such a power would meet the test prescribed in subsection (a) even though there is no separately stated power to dispose of the property.* These broad powers in the surviving spouse to use, consume, or invade give the spouse an interest equivalent to a general power of appointment, which makes the property includible in the spouse's gross estate upon death. (Emphasis added.) 85th Congress, 1st Session, House of Representatives, Report No. 1027, August 7, 1957, pp. 1, 3.

Appellants cite and rely upon Lincoln Rochester Trust Co., Adm'r v. United States, 188 F. Supp. 839 (W.D.N.Y.). In that case the district court relied upon and quoted at length from Report No. 1027. However, the judgment of the district court was reversed in United States v. Lincoln Rochester Trust Co., 297 F.2d 891 (C.A.2) and, as noted by the Court of Appeals, H.R. 8881 never became law. It was passed by the House, referred to the Senate Finance Committee and apparently pigeon-holed there. In Bill form, the Technical Amendments Act was H.R. 8381, which was not associated with House Report 1027. In its opinion in the *Lincoln Rochester Trust* case, the appellate court said, inter alia:

* As originally enacted in 1948, the provision that is now §2056(b)(5) applied only to transfers in trust, under which the surviving spouse was entitled to the income for life and could appoint the corpus. See Pipe's Estate v. Commissioner, 241 F.2d 210 (2d Cir. 1957), cert. denied, 355 U.S. 814 (legal life estate with power to consume; held, not the equivalent of trust). The provision was amended in 1954 to embrace non-trust transfers, provided the surviving spouse received a life estate and a power of appointment. By §93 of the Technical Amendments Act of 1958, the 1954 change was made retroactively applicable to the original enactment (1948) of the marital deduction, with the result that the non-trust transfer in Piatt v. Gray could qualify, although the decedent died in 1953. — Ed.

The language referred to in this report relied upon by the district court was not included in the act as finally adopted. No reliance can therefore be placed upon this portion of the report in interpreting the act.

It is apparent, therefore, that the appellants' reliance upon the district court's decision in *Lincoln Rochester Trust* and upon House Report 1027 was misplaced.

The cases upon which appellants rely in support of their claim for the allowance of a marital deduction are distinguishable as involving bequests which granted to the surviving spouse in those cases powers of disposition of much broader scope than those granted to the widow in the case at bar. See Boyd v. Gray, D.C., 175 F. Supp. 57; Stallworth's Estate v. Commissioner, 5 Cir., 260 F.2d 760; McGehee v. Commissioner, 5 Cir., 260 F.2d 818; Hoffman v. McGinnes, 3 Cir., 277 F.2d 598. In all of the last cited cases the courts held that the widow had unlimited power to invade the corpus which was exercisable by her alone and in all events. Here the widow's power was exercisable by her alone but it was not unlimited or exercisable in all events. . . .

Under her husband's will Mrs. Piatt received a legal life estate in the residue of his personal property with remainder over to the husband's sister. The surviving widow was given the right to expend all or any part of such personal property whenever in her opinion "it shall be necessary for her maintenance, comfort or well being without being required to account therefor," and the further right to sell, lease, encumber or otherwise dispose of any and all items of personal property and to give any purchaser a good fee simple title thereto. The power of appointment requirement referred to in [§2056(b)(5)] which must be exercised by the surviving spouse alone and in all events is defined variously in the Treasury Regulations as:

A power so to appoint fully exercisable in her own favor at any time following the decedent's death (as for example an unlimited power to invade).

or

The power of the surviving spouse must be a power to appoint the entire estate or a specific portion of it as unqualified owner . . . or to appoint the entire interest or a specific portion of it as a part of her estate . . . that is in effect to dispose of it to whomever she pleases. [Regs. §20.2056(b)-5(g)(1)(i) and (g)(2).]

Regs. [§20.2056(b)-5(g)(3)] enumerates the conditions under which the power is not exercisable in all events. In pertinent part this subsection provides:

Further, a power is not "exercisable in all events" if it may be exercised for a limited purpose only . . . Likewise, if there are any restrictions, either by the terms of the instrument or under applicable local law, on the exercise of a power to consume property (whether or not held in trust) for the benefit of the spouse, the power is not exercisable in all events. Thus, if a power of invasion is exercisable only for the spouse's support, or only for her limited use, the power is not exercisable in all events. In order for a power of invasion to be exercisable in all events, the surviving spouse must have the unrestricted power exercisable at any time during her life to use all or any part of the property subject to the power, and to dispose of it in any manner, including the power to dispose of it by gift (whether or not she has power to dispose of it by will).

It requires no unusual powers of discernment to perceive that the relevant statutory provisions and Treasury Regulations applicable to Item III of the testator's will demonstrate clearly that absent local law compelling a contrary conclusion, the surviving spouse did not possess such an unlimited power to invade the corpus of the estate that she is able to appoint herself in all events as an unqualified owner. Nor does she possess the power to dispose of the property by gift.

(B)

The specific legal interest created by the testator is dependent upon the law of the local jurisdiction. Helvering v. Stuart, 317 U.S. 154; Morgan v. Commissioner, 309 U.S. 78.

Appellants cite and rely upon cases decided under the law of Kentucky in which, as they contend, language similar to the terms of the Piatt will was construed as conferring upon the surviving spouse the power to appoint the corpus to herself or to her estate. At least three of such cases, however, are not fairly comparable to the case at bar. In Boyd v. Gray, D.C., 175 F. Supp. 57, 60, the bequest to the widow was of "all of the residue of my property . . . to be used, enjoyed and disposed of by her in any way she may choose." (See also Boyd v. Gray, 162 F. Supp. 307.) In Moore v. Morris, Ky., 258 S.W.2d 908, the widow was granted the power, inter alia, ". . . to sell and dispose of any of said property during her lifetime and to use the proceeds as she may see fit." In Snyder v. United States, D.C., 203 F. Supp. 195, the bequest to the widow was of "all the rest and residue of my estate . . . for and during her life with power of disposition over both the principal thereof and the income received thereform, in such manner as she may see fit." The unfettered powers of disposition bestowed upon the surviving spouses in the above cited cases is in marked contrast to the limited power of disposition conferred upon the widow in the case at bar. Mrs. Piatt did not possess the power to dispose of the property as she might see fit. She was empowered to dispose of the property only when in her opinion it was necessary for her maintenance, comfort or well-being to do so. Despite the fact that she was not required to account to any one, it was expected that the widow would exercise her discretion honestly. . . .

No definite set of principles or guide lines to aid in construction of wills emerge from an examination of the cases cited above. A few of the cases shed light upon the issue to be determined but by and large the Court must rely upon its own interpretation of the language of the will in controversy. To ascertain the intention of the testator from the language used by him is still the cardinal rule of construction. Hanks v. McDanell, 307 Ky. 243. Piatt bequeathed the residue of his personal property to his wife for her natural life with power "whenever in her opinion it shall be necessary for her maintenance, comfort or well-being to expend all or any part of the principal without being required to account therefor together with the further right and power to sell, encumber or otherwise dispose of any and all items of personal property belonging to me and to give any purchaser a good fee simple title thereto." The power of disposition is linked to the power to expend and obviously was designed to enable the surviving spouse to implement the power to use and consume that portion of the personal estate which she considered necessary for her maintenance, comfort or well-being. She was not authorized to dispose of the property "as she may see fit" or "as she may choose" or by words of similar import. She was authorized to give a good title to "any purchaser" but was not granted authority to give good title to a donee. Having reserved and exercised the right to dispose of the property by will, it is unreasonable to assume that the testator would intend that his widow could give the property away. A gift of property by the surviving spouse would have been a fraud on the testator and upon his sister who was entitled to receive the remainder of the property after Mrs. Piatt's death. . . .

Marital deductions have been denied in numerous cases from jurisdictions outside Kentucky where the facts were similar to those at bar, of which the following are representative: Estate of Semmes v. Commissioner, 288 F.2d 664 (C.A. 6th); In re Tarver's Estate v. C.I.R., 255 F.2d 913 (C.A. 4th); Commissioner v.

Ellis' Estate, 252 F.2d 109 (C.A. 3rd); May's Estate v. Commissioner, 283 F.2d 853 (C.A. 2d); United States v. Lincoln Rochester Trust Co., 297 F.2d 891 (C.A. 2), cert. den. 369 U.S. 887.

For the reasons hereinabove assigned, the judgment of the District Court is affirmed.

NOTE

1. *Life estate with power to consume.* In Field's Estate v. Commissioner, 40 T.C. 802 (1963), the Tax Court held that a surviving spouse's power under a trust "to consume my entire estate for any purposes which she shall deem advisable," which was construed by the local probate court to include the power to dispose of the property by gift, did not qualify for the marital deduction:

> We are not unmindful of the fact that the decree of the Probate Court construed the will to give [the surviving spouse] the unrestricted power to dispose of the trust property in any manner, "including the power to dispose of it by gift," and that there is some inference from language in the opinions in decided cases and the language in the last sentence of section 20.2056(b)-5(g)(3), Estate Tax Regs., that the inclusion of the power to dispose of the trust corpus by gift raises an otherwise limited power of invasion to an unlimited power to invade and thus qualifies the spouse's interest as a life estate with power of appointment under section 2056(b)(5) of the Code. We have found no cases which so hold and we think the language used in the regulations pertains only to whether a power of invasion is exercisable "in all events." While a power to dispose of by gift may be a prerequisite to qualify a power of appointment as one exercisable by the spouse "in all events," it does not follow that the power to dispose of trust corpus in any manner, including the power to dispose of it by gift, necessarily qualifies the spouse's interest as a life estate with power of appointment within the meaning of the statute. Under the language of the statute and section 20.2056(b)-5(g)(1), Estate Tax Regs., the interest of the spouse does not qualify for the marital deduction unless the spouse has the power to appoint the trust corpus to herself during her lifetime or to her estate at her death free of the trust. We do not find that either the will of the decedent in this case, as construed under Ohio law, or the decree of the Probate Court goes that far. [40 T.C. at 809-810.]

For a case in which the widow's power to consume property left to her by her husband was held to qualify the bequest for the marital deduction even though the testator provided for remainder interests in other persons on his widow's death, see Hoffman v. McGinnes, 277 F.2d 598 (3d Cir. 1960).

Why does this area give rise to so much litigation?

2. *"Marital deduction" trusts.* Section 2056(b)(5) lays down a pattern for the testator who wishes to leave property in trust for his surviving spouse without losing the marital deduction — the surviving spouse can be given the income for life, with a power (which must be exercisable by her alone and in all events) to appoint the corpus to herself or her estate. On the requirement of §2056(b)(5) that the surviving spouse must be "entitled for life to all the income . . . payable annually or at more frequent intervals," see Regs. §20.2056(b)-5(f), which deals with the effect of powers in the trustee to allocate receipts and charges between income and corpus, to retain unproductive property, to amortize bond premium, etc.; *State Street Trust Co.* case, supra page 1193; Burch, Use and Misuse of the Marital Deduction, 1963 So. Calif. Tax Inst. 609. As indicated supra page 1296n., a non-trust transfer will also qualify as a result of a statutory change in 1954; and see the *Gelb* case, infra page 1305, for the possibility of qualifying a "specific portion" of the transferred property if the surviving spouse is given the income from, and the right to appoint, that part.

A parallel provision, §2056(b)(6), permits the proceeds of insurance on the decedent's life to qualify for the marital deduction even though held by the insurance company under a settlement option, if the surviving spouse is entitled to payments of the principal or interest at annual or more frequent intervals, and can appoint the remaining amounts

payable under the contract. In Werbe's Estate v. United States, 273 F.2d 201 (7th Cir. 1959), it was held that certain minor restrictions on the surviving spouse's right to withdraw the amounts payable disqualified them because her power was not exercisable "in all events" within the meaning of §2056(b)(6). On similar facts, however, the deduction was allowed by the Tax Court in Jennings' Estate v. Commissioner, 39 T.C. 417 (1962), in which the Service has acquiesced (1964-17 I.R.B. 5).

If a testamentary trust does not provide for the periodic payment of income to the surviving spouse, but she has the unrestricted right to receive the corpus and accumulated income on demand, is the marital deduction allowable? In Halsted v. Commissioner, 28 T.C. 1069, 1074 (1957), the marital deduction was denied in computing the husband's gift tax on such a transfer, for want of a provision requiring the income to be paid "annually or at more frequent intervals" to his wife. (But see Regs. §25.2523(e)-1(f)(8), stating that the income requirement of §2523 is satisfied if the surviving spouse has "such command over the income that it is virtually hers.) In view of the wife's power to get the trust property on demand, however, has an "interest" in it been transferred to any other person?

3. *Relation of §2041 (powers of appointment) to marital deduction.* Will the unexpended portion of the assets in the *Piatt* case be includible in the widow's estate on her death? Should an affirmative answer to this question be a prerequisite to allowing a marital deduction to the husband's estate?

Consider the possibility that the surviving spouse's rights will not meet the requirements of §2056, even though they constitute a "general power of appointment" within the meaning of §2041, with the result that the unexpended property will be includible in her estate without generating an offsetting deduction for the husband's estate. One such possibility is suggested by the *Halsted* case, supra. Does *Field's Estate,* supra page 1299, suggest another disparity between §2041 and §2056? Does a power in the surviving spouse to appoint to her creditors or to the creditors of her estate, which is a general power of appointment under §2041, meet the test of §2056(b)(5) — "exercisable in favor of such surviving spouse, or of the estate of such surviving spouse"? See Snyder v. United States, 203 F. Supp. 195 (W.D. Ky. 1962) (power to appoint to donee's creditors taxable under §2041; dictum to effect that it would not qualify for marital deduction because donee could not "appoint to herself as unqualified owner"). Other disparities between the term "general power of appointment" as defined by §2041 and the type of power required by §2056(b)(5) arise from the fact that a §2056(b)(5) power must be vested solely in the surviving spouse and must be exercisable by her "in all events"; yet part of the appointive property subject to a joint power may be taxable under §2041(b)(1)(C)(iii), and a power may be subject to some limitations and yet be taxable because the standard is not within the exclusion of §2041(b)(1)(A).

Should the requirements of §2056(b)(5) and (6) be keyed more precisely to those of §2041(b) — or vice versa?

4. *"Terminable interests" — deductible and non-deductible.* The opinion in Piatt v. Gray is devoted almost entirely to the question whether the widow's life estate is embraced by §2056(b)(5). The inarticulate major premise of the opinion is that unless the conditions of §2056(b)(5) are satisfied, the widow's interest is a non-deductible "terminable interest" within the meaning of the general rule of §2056(b)(1) and hence cannot qualify for the marital deduction. Note the characteristics of a terminable interest set out in §2056(b)(1), especially (A) and (B) thereof. Were they present in Piatt v. Gray?

Patent, annuities, and rights to occupy property rent-free for a term of years are "terminable interests," since they will terminate on the lapse of time. Unless the conditions set out in subparagraphs (A) and (B) of §2056(b)(1) are satisfied, however, they can qualify for the marital deduction. See Regs. §20.2056(b)-1(c), and Examples (3), (5), and (6) of §20.2056(b)-1(g).

See also the last sentence of §2056(b)(1), disqualifying a terminable interest (even if otherwise qualified) if the decedent directs his executor or trustee to acquire it for his surviving spouse. Why is such an interest disqualified?

If the decedent's gross estate includes a non-deductible terminable interest that *could* be used to satisfy a bequest to the surviving spouse, its value must be applied against the value of otherwise qualified interests passing to her even if it is not so used. See §2056(b)(2).

5. *Elections against the will.* If the surviving spouse's interest under a will does not qualify for the marital deduction, as in Piatt v. Gray, can something be salvaged if she renounces the testamentary bequest and elects to take as in intestacy? If the elective share is otherwise qualified (i.e., if it constitutes a fee interest rather than a life estate), it rather than the disqualified testamentary bequest is considered as passing to the surviving spouse. Regs. §20.2056(e)-2(c); Harter v. Commissioner, 39 T.C. 511 (1962). If the alternative elective share would itself not qualify because it consists of a life estate in some or all of the decedent's property (e.g., common law dower), but it is commuted to a cash payment by agreement with the executor, is the deduction allowable? In United States v. Hiles. 318 F.2d 56 (5th Cir. 1963), and cases there cited, the deduction was allowed. Does *Stapf* contain intimations to the contrary?

6. *Payments to surviving spouse in settlement of will contest.* According to the Regulations, a payment to a surviving spouse in settlement of a will contest will be regarded as having "passed from the decedent to his surviving spouse" if it was a "bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate." Regs. §20.2056(e)-2(d)(2); see also Indiana Nat. Bank v. United States, 191 F. Supp. 72 (S.D. Ind. 1961). If the surviving spouse receives $500,000 in settlement of a bona fide threat to contest a will under which she was to receive a life estate worth $100,000, does the *Stapf* case suggest that only $400,000 qualifies for the marital deduction?

Conversely, if a surviving spouse is compelled by a will contest to exchange an otherwise qualified interest for an unqualified interest, the marital deduction will be denied. Tebb's Estate v. Commissioner, 27 T.C. 671 (1957) (fee interest bequeathed to widow, but threatened will contest was settled by her agreement to use property only for her normal living expenses and to leave balance to stepchildren; held, marital deduction denied because her interest was terminable).

MEYER v. UNITED STATES

364 U.S. 410 (1960)

MR. JUSTICE WHITTAKER delivered the opinion of the Court.

Petitioners, who are executors of the estate of Albert F. Meyer, brought this suit to recover an alleged overpayment of federal estate taxes and the District Court granted the relief asked. 166 F. Supp. 629. The Court of Appeals reversed, 275 F.2d 83, and we granted the executors' petition for certiorari, 361 U.S. 929, because of a conflict of decisions in the circuits. Cf. In re Reilly's Estate, 239 F.2d 797, decided by the Court of Appeals for the Third Circuit.

Two policies of life insurance are involved, but since they are in all material respects identical, we need deal with only one of them. The policy obligated the insurer to pay a death benefit of $25,187.50, and that sum was included by the executors in the federal estate tax return and the tax thereon was paid. The decedent had selected an optional mode of settlement which provided for the payment of equal monthly installments to his wife for her life, with 240 installments guaranteed, and further provided that if the wife should die before receiving the 240 installments his daughter would receive the remainder of them, but if both the wife and the daughter died before receiving the 240 installments the commuted value of those unpaid was to be paid in one sum to the estate of the last one of them to die.

Of the total proceeds of the policy of $25,187.50, the insurer determined that $17,956.41 was necessary to fund the 240 monthly payments to the wife, the daughter, or to the estate of the last survivor of them, and that the remaining $7,231.09 was necessary to fund the monthly payments to the wife so long as she might live beyond the 240 months. Accordingly, the insurer made such entries on its books.

Thereafter petitioners, as executors, timely filed a claim for refund of the amount of the tax paid upon the $7,231.09 which the insurer had shown upon its books as necessary to fund the monthly payments to the wife for her actuarial ex-

pectancy beyond the 240 months certain, on the theory that the insurer's treatment of that sum on its books created a separate "property" or fund payable to the wife alone, and hence it qualified for the marital deduction under [§2056]. The claim was denied, and this suit was brought to recover the tax that had been paid on that sum.

Petitioners correctly concede that if the policy constitutes but one "property," within the meaning of the statute,[1] it would not qualify for the marital deduction because the wife's interest in it would be a "terminable" one, within the meaning of the statute, inasmuch as the wife may die before receipt of the 240 guaranteed installments, in which event the unpaid ones must go to the daughter if then living. They concede, too, that the $17,956.41, shown on the insurer's books as necessary to fund the monthly payments for the 240 months certain, does not qualify for the marital deduction for the same reasons. But they contend that, although the policy made no provision therefor, the insurer's bookkeeping entries constituted a real division of the insurance proceeds into, and created, two "properties" — one of $17,956.41 and the other of $7,231.09 — and that the latter qualifies for the marital deduction under the statute because it is payable, if at all, only to the wife — during her lifetime beyond the 240 months — and no other person has any interest in it.

Whether a policy of life insurance may create several "properties" or funds, either terminable or nonterminable or both, we need not decide, for we think the policy here involved constituted only one property, and made only so much of its proceeds payable to the wife as she might live to receive in equal monthly installments, and made any guaranteed balance payable to the daughter. Hence, under the terms of the policy, the "interest passing to the surviving spouse [may] terminate or fail" and a "person other than [the] surviving spouse . . . may possess or enjoy [a] part of such property after such termination or failure of the interest so passing to the surviving spouse; . . ." Therefore the policy and its proceeds — considered apart from petitioners' claim that the insurer's bookkeeping division of the proceeds of the policy into two parts created two "properties" — are disqualified for the marital deduction by the express provisions of [§2056(b)(1)]. The legislative history of the section further supports and compels this conclusion. Illustrating applications of the terminable interest rule, the Senate Committee Report gave an example that is in no relevant way distinguishable from this case,[2] and makes it very clear that the marital deduction is not allowable in the case of an annuity for the surviving spouse for life if "upon the death of the surviving

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1 "The terms 'interest' and 'property,' as used in [§2056] have separate and distinct meanings. The term 'property' is used in a comprehensive sense and includes all objects or rights which are susceptible of ownership. The term 'interest' refers to the extent of ownership, that is, to the estate or the quality and quantum of ownership by the surviving spouse or other person, of particular property." S. Rep. No. 1013, Part 2, 80th Cong., 2d Sess., p. 4.

2 "*Example* (*2*). The decedent during his lifetime purchased an annuity contract under which the annuity was payable during his life and then to his spouse during her life if she survived him. The value of the interest of the decedent's surviving spouse in such contract at the death of the decedent is included in determining the value of his gross estate. A marital deduction is allowed with respect to the value of such interest so passing to the decedent's surviving spouse inasmuch as no other person has an interest in the contract. If upon the death of the surviving spouse the annuity payments were to continue for a term to her estate, or the undistributed portion thereof was to be paid to her estate, the deduction is nevertheless allowable with respect to such entire interest. *If, however, upon the death of the surviving spouse, the payments are to continue to another person* (*not through her estate*) *or the undistributed fund is to be paid to such other person, no marital deduction is allowable inasmuch as an interest passed from the decedent to such other person.*" (Emphasis added.) S. Rep. No. 1013, Part 2, 80th Cong., 2d Sess., pp. 12-13.

spouse, the payments are to continue to another person (not through her estate) or the undistributed fund is to be paid to such other person. . . ."

We think petitioners' argument — that the insurer's bookkeeping division of the proceeds of the policy into two parts created two properties — cannot withstand the provisions of the policy and the actual facts respecting the insurer's bookkeeping division of its proceeds, under the clear terms of the statute and its legislative history. The policy made no provision for the creation of two separate properties — one a property sufficient to provide payments for 240 months, to the wife while she lived and any remainder to the daughter, and another property sufficient to provide an annuity to the wife for the period of her actuarial expectancy beyond the 240 months — and no such separate properties were in fact created. The allocations made were merely actuarial ones — mere bookkeeping entries — made by the insurer on its own books for its own convenience after the insured, the other party to the contract, had died. The wife and the daughter were, respectively, primary and contingent beneficiaries *of the policy* alone. Neither of them had any title to, nor right to receive, any special fund, and indeed none was actually created. The bookkeeping entries made by the insurer no more created or measured their rights than the insurer's erasure of those entries — which it was free to make at any time — would destroy their rights. Their rights derive solely from the policy. It, not the insurer's bookkeeping entries, created and constitutes the property involved. Any action by the beneficiaries to enforce their rights against the insurer would have to be upon the policy, not upon the entries the insurer had made on its books for its own actuarial information and convenience. Nor would exhaustion of the sum of those entries constitute any defense to the insurer against the claim of either beneficiary for amounts due her under the policy.

The proceeds of the policy were not payable to the wife (or to her estate or appointee) alone and at all events, but were payable in monthly installments to her for life, and if any obligation under the policy remained undischarged at her death it was payable to the daughter if living or, if not, to the estate of the last of them to die. It follows that the "interest passing to the surviving spouse [may] terminate or fail" and that a "person other than [the] surviving spouse . . . may possess or enjoy [a] part of such property after such termination or failure of the interest so passing to the surviving spouse; . . ." and hence the property is disqualified for the marital deduction by the express provisions of [§2056(b)(1)].

Affirmed.

Mr. Justice Douglas, with whom Mr. Justice Clark and Mr. Justice Brennan concur, dissenting.

The decedent had two life insurance policies in two separate companies; and each provided for the payment of the proceeds in 20 annual instalments by monthly payments to decedent's wife, Marion E. Meyer, if living, and thereafter during her lifetime. If the wife was not living at decedent's death, the instalments were to be paid to a daughter. If the wife died after decedent and before payment in full of the instalments, any remaining instalments were to be payable to the daughter. If the wife lived beyond the 20 years, she would be entitled to like monthly payments for her life. Decedent was survived by his wife and daughter, the wife being then 42 years old.

The insurance companies calculated the sums necessary to provide the designated monthly payments for 20 years: $17,956.41 in the case of one policy and $4,012.24 in the case of the other. They then computed the amount necessary to provide a monthly income to the wife in the event she lived beyond the 20-year period: $7,231.09 for one policy; $1,007.36 for the other.

Neither of the policies provided (and decedent did not request) that there be

any segregation of the proceeds between the amounts computable for the term certain and for funding of the contingent life annuity.[1] The amounts required to provide monthly payments for 20 years — $17,956.41 and $4,012.24 — were not claimed as marital deductions. This controversy concerns only the amount needed to fund the contingent life annuities of the wife — $7,231.09 plus $1,007.36, or $8,238.45, which the executors claim as a marital deduction.

Concededly the amount necessary to make the 20-year payments does not qualify as a marital deduction because it may "terminate or fail" within the meaning of the Code, the daughter being entitled to any remaining payments during that term should the wife die before it terminates. The daughter, however, has no *interest* in the annuities payable beyond the 20-year period. And it seems to me that the wife's "interest" in that part of the insurance contracts does not "terminate or fail" within the meaning of [§2056(b)(1)].

If the decedent had taken out *one group of policies* to pay instalments for 20 years to his wife or, if she died within that period, to his daughter, and *another group of policies* to pay instalments to his wife for life if she lived more than 20 years, the former would be nondeductible, but the latter would qualify for the marital deduction.[2] Does then the continuation of the two types of insurance in one policy change the result? The Government maintains that it does because in its view the entire insurance proceeds of each policy are a single "property" as that term is used in the statute; and the Court so holds. Yet, with all deference, that conclusion is wide of the mark.

The Senate Report states that terminable *interests* include all *interests* that are subject to contingencies and conditions. Yet these contingencies and conditions are not all-inclusive. They do not include the death of the transferee. And, as I shall show, contingencies of the kind we have here are not included.

The Court, with all deference, errs in making its decision turn on whether the wife's *interest* after the 20-year term is a separate "property" within the meaning of the statute. The ruling of the Court is on a statutory provision that does not exist. Under the statute the question is not whether "property" is terminable; it is whether an "interest" is terminable. The statute indeed draws a marked distinction between "property" and "interest." Section [2056(a)] speaks not of "property," but of any "interest" in property. Section [§2056(b)] speaks only of an "interest passing to the surviving spouse" that will "terminate or fail." The statute at these points is concerned with "interest" in property — not with "property." Yet the Court, disregarding the statutory scheme, looks only to "property" and finding but one insurance policy denies the deduction.

Plainly there may be more than one "interest" in a single "property." A deduction is not denied merely because the surviving spouse and someone else each have an "interest" in the same "property." S. Rep. No. 1013, 80th Cong., 2d Sess., Pt. 2, p. 8. The Senate Committee gave several examples: ". . . if the decedent by his will devises Blackacre to his wife and son as tenants in common, the marital deduction is allowed, since the surviving spouse's interest is not a terminable interest."

There seems to me to be a like separation of *interests* in the present case. These

[1] It was said, however, on oral argument the insurance companies maintained for their own records separate accounts as to the 20-year monthly income provisions and the contingent life annuity of the wife, without any segregation of funds.

[2] The Court of Appeals in *In re Reilly's Estate,* supra, correctly noted that the purpose of the marital deduction under this Act was "to make more nearly uniform the tax treatment of married persons in community property and non-community property states." Id., at 799. The assets not taxable in the estate of the first spouse to die may be taxed at the death of the survivor. In other words, the property in the marital community is subject to the tax only once in the estate of either.

insurance policies created, of course, no fund or res. The sum of $21,968.65 representing the wife's terminable *interest* and the $8,238.45 representing her other *interest* were, of course, no more segregated in the insurance companies' assets than a customer's checking account is segregated in a commercial bank. Yet that seems immaterial. Each represented a chose in action. The wife or daughter, as the case might be, could sue for the one during the 20-year period. Only the wife could enforce the claim here in question.

That the proceeds of one life insurance policy may create two or more "interests" for purposes of the estate tax is implicit in the Senate Report. Thus one example of a marital deduction that is given is an annuity payable to the decedent during his life and to his spouse during her life if she survived him.

> The decedent during his lifetime purchased an annuity contract under which the annuity was payable during his life and then to his spouse during her life if she survived him. The value of the interest of the decedent's surviving spouse in such contract at the death of the decedent is included in determining the value of his gross estate. A marital deduction is allowed with respect to the value of such interest so passing to the decedent's surviving spouse inasmuch as no other person has an interest in the contract. If upon the death of the surviving spouse the annuity payments were to continue for a term to her estate, or the undistributed portion thereof was to be paid to her estate, the deduction is nevertheless allowable with respect to such entire interest. If, however, upon the death of the surviving spouse, the payments are to continue to another person (not through her estate) or the undistributed fund is to be paid to such other person, no marital deduction is allowable inasmuch as an interest passed from the decedent to such other person. Id., pp. 12-13.

The last sentence of the foregoing quotation, on which the Court relies, describes with accuracy the terminable "interest" of the wife in that part of the annuity payable during the 20-year period after the death of the decedent. It has no relevancy to the "interest" with which we are here concerned, viz., the instalments payable after that 20-year period.

My conclusion is that where the "interest" that accrues to the surviving spouse is, as here, shared with no one else and is subject to no termination except her own death, it qualifies for a marital deduction under this statute, even though another "interest" of hers in the same annuity contract would not qualify.

GELB v. COMMISSIONER

298 F.2d 544 (2d Cir. 1962)

Before CLARK, FRIENDLY and KAUFMAN, Circuit Judges.

FRIENDLY, Circuit Judge.

The executors under the will of Harry Gelb petition for review of a decision of Judge Opper in the Tax Court, 19 T.C.M. 987, which sustained the Commissioner's determination that a residuary trust created by the will did not qualify for the marital deduction. We agree that no deduction was warranted under §812(e)(1)(F) of the Internal Revenue Code of 1939, which was in effect at Gelb's death. However, we hold that a "specific portion" of the trust qualified for the deduction under the retrospective amendment of that section made by §93(a) of the Technical Amendments Act of 1958, 72 Stat. 1606, 1668.

I

The critical provisions of the residuary clause of the will, executed May 27, 1953, are set out in the margin.[1] At the date of Gelb's death, November 16, 1953,

[1] "FIFTH: All the rest, residue and remainder of my property, whether real or personal, and wheresoever situated which I may own or to which I may be entitled at the time of my death, I

the governing statute, cited above, provided that "an interest in property passing from the decedent in trust" should qualify for the marital deduction "if under the terms of the trust his surviving spouse is entitled for life to all the income from the corpus of the trust, payable annually or at more frequent intervals, with power in the surviving spouse to appoint the entire corpus free of the trust (exercisable in favor of such surviving spouse, or of the estate of such surviving spouse, or in favor of either, whether or not in each case the power is exercisable in favor of others), and with no power in any other person to appoint any part of the corpus to any person other than the surviving spouse." The statute added that the provision "shall be applicable only if, under the terms of the trust, such power in the surviving spouse to appoint the corpus, whether exercisable by will or during life, is exercisable by such spouse alone and in all events."

There is no doubt that the residuary trust would fit the statute save for the paragraph with respect to Claire. We find no merit in the Commissioner's contention that this provision violated the requirement that the surviving spouse must be "entitled for life to all the income from the corpus of the trust." The language of the will is plain that the provision in regard to Claire was an additional power to invade corpus, not one to divert income from the widow; if the language were ambiguous, which it is not, the fact that the trust income ranged only from some $3000 to $3500 a year, a probability hardly unknown to the testator, would be determinative in taxpayers' favor. However, the Commissioner and the Tax Court were right that the provision infringed the requirement that there must be "no power in any other person to appoint any part of the corpus to any person other than the surviving spouse," and the converse that the power of the surviving spouse to appoint the entire corpus must be "exercisable by such spouse alone and in all events."

[The court concluded that Claire possessed an enforceable right to receive payments from the trust when the conditions contemplated by the decedent occurred, and that the surviving spouse, even if she were a trustee when the standard was met, could not properly prevent the making of such payments.]

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give, devise and bequeath to my Trustees hereinafter named IN TRUST nevertheless, to invest, reinvest, and keep the same invested for and during the life of my beloved wife, ROSE GELB, and to collect and pay over to her during her life, in monthly installments, the net income therefrom. In the event that the net income payable to my beloved wife during any year shall amount to less than Ten Thousand ($10,000.00) Dollars, I direct my Trustees to draw upon the principal of the trust fund to the extent of such deficit, and pay such difference to my beloved wife, it being my intent that my beloved wife shall receive at least the sum of Ten Thousand ($10,000.00) Dollars per year in installments of Eight Hundred Thirty-Three and 33/100 ($833.33) Dollars per month from my estate during her life." . . .

"I particularly wish to provide for the support and education of my youngest daughter, CLAIRE LILA GELB. Accordingly, I direct that if, in any year or years, my individual Trustees desire funds from said trust fund to provide for the education, maintenance and upbringing of my said youngest daughter, CLAIRE LILA GELB, then upon application of my individual Trustees, in their sole discretion, my Executors and Trustees are hereby directed to pay to my beloved wife such sums as such individual Trustees shall in writing request, not exceeding the sum of Five Thousand ($5,000.00) Dollars per year and I authorize my individual Trustees to apply said sums so requested and paid for the proper support, maintenance, education and up-bringing of my said daughter, CLAIRE LILA GELB. The receipt of my individual Trustees for such sums shall constitute an acquittance therefor. The said payments referred to in this numbered paragraph shall be in addition to all other payments provided for by this Will to be made during the lifetime of my said wife." . . .

"Upon the death of my said wife, my Trustees are directed to pay over and distribute the then corpus of this trust, to her estate or to any persons or corporations, in such estates, interest and proportions, either outright or in trust and in such manner, without any restriction or limitation whatsoever, as my said wife shall validly appoint by her Last Will and Testament. In default of such valid appointment, the then corpus shall, upon the death of my said wife, be distributed outright or in trust as provided for in paragraph 'SIXTH' of my said Will, as though my wife had predeceased me."

II

The provision of the Internal Revenue Code of 1954, §2056(b)(5), with respect to the qualification for the marital deduction of trusts for the surviving spouse, altered the previous law in an important way. Under the earlier statute, unless a trust qualified in whole, no part of it did. The 1954 Code introduced a new concept — a qualifying "specific portion." Section 93(b) of the Technical Amendments Act of 1958, 72 Stat. 1606, passed after the petition here had been filed in the Tax Court but long prior to the decision, made the new dispensation applicable to estates of decedents who had died after April 1, 1948 and before August 17, 1954, when the provision of the 1954 Code took effect; . . . However, neither the counsel who represented taxpayers in the Tax Court, the Commissioner, nor the Court itself, considered the effect of the amendment, as the Commissioner now properly concedes must be done.

Counsel representing the taxpayers in this court contends that if we reject his argument as to the entire trust, at least "a specific portion" qualifies for the marital deduction — namely, so much of the corpus as could not be diverted to Claire, the latter amount equalling the present value of $5,000 multiplied by Rose's expectancy (more accurately by Rose's and Claire's joint expectancy). The Commissioner says this is not what Congress meant by "a specific portion." He points to the example given in all the Congressional reports, both as to the 1954 Code and the 1958 amendment, namely, that if a testator leaves his spouse the annual income from one-half of the property, and gives her a power of appointment over one-half the property, then one-half the value of the property is deductible. He points also to the reports on the 1954 Code which said "The bill makes it clear . . . that a right to income plus a general power of appointment over only an undivided part of the property will qualify that part of the property for the marital deduction." H. Rep. No. 1337, S. Rep. No. 1622, and to the Senate report on the 1958 Act, S. Rep. No. 1983, which said "Your committee, therefore, has amended the House bill to add a provision to conform the marital deduction provisions of the 1939 Code with the more realistic rules of the 1954 Code." He urges still more vigorously the language of the Regulations, first adopted as §20.2056 (b)-5(c) under the 1954 Code . . . and later made applicable to estates entitled to the benefit of the 1958 amendment to the 1939 Code. . . .

The Commissioner does not argue that the divergence between the extent of Rose's right to income and her power to appoint prevents her interest from constituting a "specific portion." One of the purposes of the 1958 amendment was to remedy the situation under the 1939 Code wherein the deduction was lost altogether unless both these factors were 100%, S. Rep. No. 1983, 85th Cong., 2d Sess., and the Commissioner has recognized that "While the rights over the income and the power must coexist as to the same interest in property, it is not necessary that the rights over the income or the power as to such interest be in the same proportion," Regulations 105, §81.47a(c)(2), added by T.D. 6529 [1961-1 C.B. 753, 768], the deduction being limited to whichever is smaller as between the share over which the power to appoint corpus extends and that to which the income rights pertain. The Commissioner's argument is rather that here even the smaller portion, that over which the right to appoint corpus extends, does not qualify because it is not the "fractional or percentile share" demanded by [Regs. §20.2056(b)-5(c)].

We fail to comprehend why a life interest in a residuary trust which at testator's death amounted to $200,000 and a qualifying power to appoint $100,000 out of it, or a life interest in such a trust and a qualifying power to appoint all

but $100,000 out of it, do not relate to a "specific portion," namely, $100,000, quite as much as if the testator had used a fraction or a percentage with respect to the power over corpus. Example (1) [of Regs. §20.2056(b)-5(c)] says the reason why a trust where the spouse has been given a qualifying power over a specified dollar amount does not meet the statutory test is that "there is no certainty that the value" of the entire corpus "will be the same on the date of the surviving spouse's death as it was on the date of the decedent's death," so that a specific dollar amount fails to meet the Regulations' stricture that the widow's share must reflect "its proportionate share of the increment or decline in the whole of the property" in trust. This elaboration of the statutory language seems to bespeak a desire that the risk of change in value, up or down, should be shared equally by the spouse and the Government. True, when the power is to draw a specific dollar amount the spouse bears no risk of change in the value of the corpus, unless, indeed, it shrinks below the dollar figure; and when the power is over all the corpus except a named dollar amount, the spouse is saddled with a disproportionate risk. However, Congress spoke of a "specific portion," not of a "fractional or percentile share," and nowhere indicated any policy that deductibility of a "specific portion" should be governed by the possibility that the spouse's portion will change in value relatively more or less than the clearly nonqualifying part. Neither has the Commissioner given us any reason why this should be so. A basic purpose of the marital deduction was to reduce the discrimination against taxpayers not in community property states, S. Rep. No. 1013, 80th Cong., 2d Sess., in 1948-1 C.B. at pp. 305-306; see Commissioner v. Estate of Ellis, 252 F.2d 109, 112 (3 Cir. 1958). The liberalization in the provision as to trusts, made in the 1954 Code and applied to earlier years by the Technical Amendments Act, was evidently designed to permit certain normal testamentary dispositions without the total forfeiture of the deduction that the 1939 Code had occasioned in some instances. That Congress gave a fractional interest as an example of a "specific portion" does not warrant a construction that Congress did not mean to include other instances fairly within the language and the underlying policy. We disapprove [Regs. §20.2056(b)-5(c)] insofar as it would limit a "specific portion" to "a fractional or percentile share."

However, the taxpayers here encounter an added difficulty. Rose's qualifying power was not over the entire corpus less a sum described in dollars, but over all less a sum which can at best be estimated by actuarial calculations. It is surely arguable that in the latter case the power is not exercisable over a "specific portion" even though in the former it is — the joint lives of Rose and Claire might differ substantially from their actuarial expectancy. Yet the use of actuarial tables for dealing with estate tax problems has been so widespread and of such long standing that we cannot assume Congress would have balked at it here; the United States is in business with enough different taxpayers so that the law of averages has ample opportunity to work.

The case is remanded to the Tax Court to determine how much of the residuary trust qualifies for the marital deduction under the principles herein stated. The Court should consider whether the power in respect to Claire is not a qualifying power to the extent that it is exercisable during her minority, Regulations [§20.2056(b)-5(j), providing that a power to distribute corpus to the surviving spouse for the support of minor children will not disqualify the trust if she is legally obligated to support them.]

NOTE

"Specific portion." Compare the interpretation of the term "the property" in §2503(c) in the *Herr* case, supra page 1065.

JACKSON v. UNITED STATES

376 U.S. 503 (1964)

MR. JUSTICE WHITE delivered the opinion of the Court.

Since 1948 [§2056(a)] has allowed a "marital deduction" from a decedent's gross taxable estate for the value of interests in property passing from the decedent to his surviving spouse. [Section 2056(b)] adds the qualification, however, that interests defined therein as "terminable" shall not qualify as an interest in property to which the marital deduction applies. The question raised by this case is whether the allowance provided by California law for the support of a widow during the settlement of her husband's estate is a terminable interest.

Petitioners are the widow-executrix and testamentary trustee under the will of George Richards who died a resident of California on May 27, 1951. Acting under the Probate Code of California, the state court, on June 30, 1952, allowed Mrs. Richards the sum of $3,000 per month from the corpus of the estate for her support and maintenance, beginning as of May 27, 1951, and continuing for a period of 24 months from that date. Under the terms of the order, an allowance of $42,000 had accrued during the 14 months since her husband's death. This amount, plus an additional $3,000 per month for the remainder of the two-year period, making a total of $72,000, was in fact paid to Mrs. Richards as widow's allowance.

On the federal estate tax return filed on behalf of the estate, the full $72,000 was claimed as a marital deduction under [§2056]. The deduction was disallowed, as was a claim for refund after payment of the deficiency, and the present suit for refund was then brought in the District Court. The District Court granted summary judgment for the United States, holding, on the authority of Cunha's Estate v. Commissioner, 279 F.2d 292, that the allowance to the widow was a terminable interest and not deductible under the marital provision of the Internal Revenue Code. The Court of Appeals affirmed, 317 F.2d 821, and we brought the case here because of an asserted conflict between the decision below and that of the Court of Appeals for the Fifth Circuit in First National Bank & Trust Co. of Augusta v. United States, 297 F.2d 312. 375 U.S. 894. For the reasons given below, we affirm the decision of the Court of Appeals.

In enacting the Revenue Act of 1948 with its provision for the marital deduction, Congress left undisturbed §812(b)(5) of the 1939 Code, which allowed an estate tax deduction, as an expense of administration, for amounts "reasonably required and actually expended for the support during the settlement of the estate of those dependent upon the decedent." As the legislative history shows, support payments under §812(b)(5) were not to be treated as part of the marital deduction allowed by [§2056]. The Revenue Act of 1950, however, repealed §812-(b)(5) because, among other reasons, Congress believed the section resulted in discriminations in favor of States having liberal family allowances.[1] Thereafter

[1] The legislative history states: "In practice [the support allowance deduction] has discriminated in favor of estates located in States which authorize liberal allowances for the support of dependents, and it has probably also tended to delay the settlement of estates." S. Rep. No. 2375, 81st Cong., 2d Sess., p. 57.

allowances paid for the support of a widow during the settlement of an estate "heretofore deductible under section 812(b) will be allowable as a marital deduction subject to the conditions and limitations of [§2056]." S. Rep. No. 2375, 81st Cong., 2d Sess., p. 130.

The "conditions and limitations" of the marital deduction under [§2056] are several but we need concern ourselves with only one aspect of [§2056(b)(1)], which disallows the deduction of "terminable" interests passing to the surviving spouse. It was conceded in the Court of Appeals that the right to the widow's allowance here involved is an interest in property passing from the decedent within the meaning of [§2056(e)], that it is an interest to which the terminable interest rule of [§2056(b)(1)] is applicable, and that the conditions set forth in [(A) and (B) of §2056(b)(1)] were satisfied under the decedent's will and codicils thereto. The issue, therefore, is whether the interest in property passing to Mrs. Richards as widow's allowance would "terminate or fail" upon the "lapse of time, upon the occurrence of an event or contingency, or upon the failure of an event or contingency to occur."

We accept the Court of Appeals description of the nature and characteristics of the widow's allowance under California law. In that State, the right to a widow's allowance is not a vested right and nothing accrues before the order granting it. The right to an allowance is lost when the one for whom it is asked has lost the status upon which the right depends. If a widow dies or remarries prior to securing an order for a widow's allowance, the right does not survive such death or remarriage. The amount of the widow's allowance which has accrued and is unpaid at the date of death of the widow is payable to her estate but the right to future payments abates upon her death. The remarriage of a widow subsequent to an order for an allowance likewise abates her right to future payments. 317 F.2d 821, 825.

In light of these characteristics of the California widow's allowance, Mrs. Richards did not have an indefeasible interest in property at the moment of her husband's death since either her death or remarriage would defeat it. If the order for support allowance had been entered on the day of her husband's death, her death or remarriage at any time within two years thereafter would terminate that portion of the interest allocable to the remainder of the two-year period. As of the date of Mr. Richards' death, therefore, the allowance was subject to failure or termination "upon the occurrence of an event or contingency." That the support order was entered in this case 14 months later does not, in our opinion, change the defeasible nature of the interest.

Petitioners ask us to judge the terminability of the widow's interest in property represented by her allowance as of the date of the Probate Court's order rather than as of the date of her husband's death. The court's order, they argue, unconditionally entitled the widow to $42,000 in accrued allowance of which she could not be deprived by either her death or remarriage. It is true that some courts have followed this path, but it is difficult to accept an approach which would allow a deduction of $42,000 on the facts of this case, a deduction of $72,000 if the order had been entered at the end of two years from Mr. Richards' death and none at all if the order had been entered immediately upon his death. Moreover, judging deductibility as of the date of the Probate Court's order ignores the Senate Committee's admonition that in considering terminability of an interest for purposes of a marital deduction "the situation is viewed as at the date of the decedent's death." S. Rep. No. 1013, 80th Cong., 2d Sess., Part 2, p. 10. We prefer the course followed by both the Court of Appeals for the Ninth Circuit in *Cunha's Estate,* supra, and by the Court of Appeals for the Eighth Circuit in United States v. Quivey, 292 F.2d 252. Both courts have held the date of death

of the testator to be the correct point of time from which to judge the nature of a widow's allowance for the purpose of deciding terminability and deductibility under [§2056]. This is in accord with the rule uniformly followed with regard to interests other than the widow's allowance, that qualification for the marital deduction must be determined as of the time of death.[2]

Our conclusion is confirmed by [§2056(b)(3)] which saves from the operation of the terminable interest rule interests which by their terms may (but do not in fact) terminate only upon failure of the widow to survive her husband for a period not in excess of six months. The premise of this provision is that an interest passing to a widow is normally to be judged as of the time of the testator's death rather than at a later time when the condition imposed may be satisfied; hence the necessity to provide an exception to the rule in the case of a six months' survivorship contingency in a will. A gift conditioned upon eight months' survivorship, rather than six, is a nondeductible terminable interest for reasons which also disqualify the statutory widow's allowance in California where the widow must survive and remain unmarried at least to the date of an allowance order to become indefeasibly entitled to any widow's allowance at all.

Petitioners contend, however, that the sole purpose of the terminable interest provisions of the Code is to assure that interests deducted from the estate of the deceased spouse will not also escape taxation in the estate of the survivor. This argument leads to the conclusion that since it is now clear that unless consumed or given away during Mrs. Richards' life, the entire $72,000 will be taxed to her estate, it should not be included in her husband's. But as we have already seen, there is no provision in the Code for deducting all terminable interests which become nonterminable at a later date and therefore taxable in the estate of the surviving spouse if not consumed or transferred. The examples cited in the legislative history make it clear that the determinative factor is not taxability to the surviving spouse but terminability as defined by the statute. Under the view advanced by petitioners all cash allowances actually paid would fall outside [§2056(b)(1)]; on two different occasions the Senate has refused to give its approval to House-passed amendments to the 1954 Code which would have made the terminable interest rule inapplicable to all widow's allowances actually paid within specified periods of time.

We are mindful that the general goal of the marital deduction provisions was to achieve uniformity of federal estate tax impact between those States with community property laws and those without them. But the device of the marital deduction which Congress chose to achieve uniformity was knowingly hedged with limitations, including the terminable interest rule. These provisions may be imperfect devices to achieve the desired end, but they are the means which Congress chose. To the extent it was thought desirable to modify the rigors of the terminable-interest rule, exceptions to the rule were written into the Code. Courts should hesitate to provide still another exception by straying so far from the statutory language as to allow a marital deduction for the widow's allowance provided by the California statute. The achievement of the purposes of the marital deduction is dependent to a great degree upon the careful drafting of wills; we have no fear that our decision today will prevent either the full utilization of the marital deduction or the proper support of widows during the pendency of an estate proceeding.

Affirmed.

MR. JUSTICE DOUGLAS dissents.

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[2] Bookwalter v. Lamar, 323 F.2d 664 (C.A. 8th Cir.); United States v. Mappes, 318 F.2d 508 (C.A. 10th Cir.); Commissioner v. Ellis' Estate, 252 F.2d 109 (C.A. 3d Cir.); Starrett v. Commissioner, 223 F.2d 163 (C.A. 1st Cir.); Estate of Sbicca v. Commissioner, 35 T.C. 96.

NOTE

1. *Widows' allowances.* As a result of a 1961 amendment, a widow's (or widower's) allowance in Connecticut "shall vest in [the survivor] upon the death of his spouse and shall not terminate with his subsequent death or remarriage." Is this sufficient to qualify the allowance for the marital deduction? Note that the purpose of the allowance is to support the surviving spouse during administration of the estate and that its amount depends upon the probate judge's estimate of the time required for administration. Are these disqualifying conditions under §2056(b)(1)? What would be the effect of an order under the Connecticut statute directing the executor to pay the widow $100 weekly until the estate is finally settled? See Second Nat. Bank of New Haven v. United States, 222 F. Supp. 446 (D. Conn. 1963) (dictum, 1961 Connecticut amendment qualifies); Note, The Widow's Allowance and the Marital Deduction, 77 Harv. L. Rev. 533 (1964) (published prior to *Jackson* case); Mahon, The Widow's Allowance and the Federal Tax Laws, 41 Taxes 692 (1963) (re income tax results of widow's allowance to estate and to recipient).

2. *Transfers to spouse conditioned on surviving to a specified time.* Section 2056(b)(3) provides that an interest is not to be considered as terminable solely because it will fail if the surviving spouse dies within 6 months of the decedent's death or in a common disaster (provided the event does not occur), but other conditions of survivorship may be fatal. Thus, in Bookwalter v. Lamar, 323 F.2d 664 (8th Cir. 1963), it was held that a bequest to the decedent's widow conditioned on her surviving administration of his estate created a non-qualified terminable interest. A similar clause was held non-terminable in Kellar v. Kasper, 138 F. Supp. 738 (D.S.D. 1956), however, on the ground that under local law, title was indefeasibly vested in the widow at the time of the husband's death. The court found that the language of the will was "ambiguous" but that the testator, "astute lawyer that he was, can be presumed to have understood the marital deduction provision of the law, and the record shows that he redrew his will for the sole purpose of taking advantage of such marital deduction," and held that weight must be given to this purpose in construing the language of the will.

In Rev. Rul. 54-121, 1954-1 C.B. 196, the Internal Revenue Service ruled that insurance proceeds received by the decedent's widow would not qualify for the marital deduction if she was to take only if alive when the insurance company received due proof of the insured's death, since that might occur more than six months after his death. But see Eggleston v. Dudley, 257 F.2d 398 (3d Cir. 1958), holding that under local law, taking into account the intent of the insured, such a clause created a vested rather than terminable interest, so as to qualify for the marital deduction.

See also Starrett v. Commissioner, 223 F.2d 163 (1st Cir. 1955) (surviving spouse's power to invade corpus of a trust of which she was the income beneficiary would terminate upon her legal incapacity or upon the appointment of a guardian of her person or property; held, although power would ordinarily be *suspended* during disability and interest would not be disqualified, the condition in dispute *terminated* the power upon disability, so that spouse's recovery would not restore her power of invasion — hence, interest is disqualified).

3. *Common disaster clauses and the "all events" requirement of §2056(b)(5) and (6).* Section 2056(b)(5) creates an exception to the terminable interest rule for trusts under which the surviving spouse is entitled to the income and can appoint the corpus (or a specific portion thereof) to himself or his estate, provided the power is exercisable "by such spouse alone and in all events." If the power is created by a will containing a common disaster clause, is the widow's power exercisable "in all events" in view of the fact that it will not come into play if she fails to survive the common disaster? A similar question arises under the "all events" test of §2056(b)(6), relating to life insurance proceeds. See Davis, Effect of a Time Delay Clause on the Marital Deduction Where Periodic Payments Must Qualify Under Section 2056(b)(5) or Section 2056(b)(6), 51 Ill. B.J. 752 (1963).

REV. PROC. 64-19

1964-15 I.R.B. 30

SECTION 1. PURPOSE.

The purpose of this Revenue Procedure is to state the position of the Internal Revenue Service relative to allowance of the marital deduction in cases where there is some uncertainty as to the ultimate distribution to be made in payment of a pecuniary bequest or transfer in trust where the governing instrument provides that the executor or trustee may satisfy bequests in kind with assets at their value as finally determined for Federal estate tax purposes.

SEC. 2. BACKGROUND.

.01 The Internal Revenue Service has received inquiries concerning the amount of the marital deduction which should be allowed for a pecuniary bequest in a will or for a transfer in trust of a pecuniary amount where the governing instrument not only provides that the executor or trustee may, or is required to, select assets in kind to satisfy the bequest or transfer, but also provides that any assets distributed in kind shall be valued at their values as finally determined for Federal estate tax purposes. The question is the same whether the amount of the bequest or transfer is determined by a formula fixing it by reference to the adjusted gross estate of the decedent as finally determined for Federal estate tax purposes, or its amount is determined in some other fashion by which a fixed dollar amount distributable to the surviving spouse can be computed. Any bequest or transfer in trust described in subsection 2.01 is hereinafter referred to as a "pecuniary bequest or transfer" for purposes of this Revenue Procedure.

.02 Where, by virtue of the duties imposed on the fiduciary either by applicable state law or by the express or implied provisions of the instrument, it is clear that the fiduciary, in order to implement such a bequest or transfer, must distribute assets, including cash, having an aggregate fair market value at the date, or dates, of distribution amounting to no less than the amount of the pecuniary bequest or transfer, as finally determined for Federal estate tax purposes, the marital deduction may be allowed in the full amount of the pecuniary bequest or transfer in trust. Alternatively, where, by virtue of such duties, it is clear that the fiduciary must distribute assets, including cash, fairly representative of appreciation or depreciation in the value of all property thus available for distribution in satisfaction of such pecuniary bequest or transfer, the marital deduction is equally determinable and may be allowed in the full amount of the pecuniary bequest or transfer in trust passing to the surviving spouse.

.03 In many instances, however, by virtue of the provisions of the will or trust, or by virtue of applicable state law (or because of an absence of applicable state decisions), it may not be clear that the discretion of the fiduciary would be limited in this respect, and it cannot be determined that he would be required to make distribution in conformance with one or the other of the above requirements or that one rather than the other is applicable. In such a case, the interest in property passing from the decedent to his surviving spouse would not be ascertainable as of the date of death, if the property available for distribution included assets which might fluctuate in value.

SEC. 3. INSTRUCTIONS TO TAXPAYERS AND SERVICE PERSONNEL.

.01 In cases where it is not clear on the record available that the discretion of the executor would be limited, as set forth in section 2.02, the marital deduction may nevertheless be allowed for the value of such a pecuniary bequest or transfer in trust, under an instrument executed prior to October 1, 1964, if the Internal Revenue Service receives appropriate agreements from the fiduciary

and the surviving spouse that the assets of the estate, both cash and other property, available for distribution will be so distributed between the marital deduction bequest or transfer in trust and the balance of the estate available for distribution in satisfaction of such pecuniary bequest or transfer that the cash and other property distributed in satisfaction of the marital deduction pecuniary bequest or transfer in trust will be fairly representative of the net appreciation or depreciation in the value of the available property on the date or dates of distribution. The execution and performance of such an agreement will not constitute a gift.

.02 If the fiduciary fails to make distribution in accordance with the agreements executed pursuant to the preceding paragraph, and the value of the assets distributed to satisfy the marital bequest or transfer in trust is less than the amount required by such agreements, the surviving spouse will be considered to have made a gift or gifts to the beneficiaries in whose favor the failure occurs, as of the date, or dates, of distribution, unless the surviving spouse, when apprised of the situation, promptly objects and takes those steps appropriate under applicable state law to rectify it.

SEC. 4. SCOPE.

.01 The problem here considered is restricted to the situation involving bequests and transfers in trust described in sections 1 and 2.01. It does not arise in other cases, for example:

(1) In a bequest or transfer in trust of a fractional share of the estate, under which each beneficiary shares proportionately in the appreciation or depreciation in the value of assets to the date, or dates, of distribution.

(2) In a bequest or transfer in trust of specific assets.

(3) In a pecuniary bequest or transfer in trust, whether in a stated amount or an amount computed by the use of a formula, if:

(a) The fiduciary must satisfy the pecuniary bequest or transfer in trust solely in cash, or

(b) The fiduciary has no discretion in the selection of the assets to be distributed in kind, or

(c) Assets selected by the fiduciary to be distributed in kind in satisfaction of the bequest or transfer in trust are required to be valued at their respective values on the date, or dates, of their distribution.

.02 This Revenue Procedure does not relate to any issue arising under the income tax provisions of the Internal Revenue Code.

[Section 5, prescribing the form of agreements to meet the requirements of §3, omitted.]

NOTE

1. *Effect of executor's discretion.* If the executor is not required by local law to make a distribution to the widow that is no less than the pecuniary bequest or that is fairly representative of the appreciation or depreciation in the value of all property distributable in satisfaction of the bequest, does Rev. Proc. 64-19 adopt the view that the marital deduction is to be disallowed in toto? On what part of §2056 does the Internal Revenue Service rely in expressing the view that disallowance is justified?

On local law, see In re Inman's Estate, 196 N.Y.S.2d 369 (N.Y. Surr. 1959) (marital deduction trust is to share in appreciation and depreciation to date of distribution); Matter of Mueller, 34 Misc. 2d 584 (N.Y. 1962); In re Althouse's Estate, 172 A.2d 146 (Pa. 1961) (marital bequest treated as pecuniary gift rather than fractional share of residue; held, it does not participate in appreciation). If there is no controlling local statute or prior decision, will the disallowance threatened by Rev. Proc. 64-19 be avoided if the pro-

bate court having jurisdiction of the estate in question directs that the distribution meet one of the two conditions set out in §2.02?

2. *Income tax effect of using appreciated or depreciated property.* Revenue Proc. 64-19 refrains from commenting on the income tax effect of a distribution of appreciated or depreciated property. Revenue Rul. 56-270, 1956-1 C.B. 325, ruled that a marital deduction clause providing for a bequest equal to the maximum allowable marital deduction creates a pecuniary obligation, so that the use of appreciated or depreciated assets to satisfy the bequest constitutes a taxable realization by the estate of the increase or decrease in value between the date of death (or the optional valuation date) and the date of distribution. The ruling relied on Kenan v. Commissioner and Suisman v. Eaton, supra page 438. See also Rev. Rul. 60-87, 1960-1 C.B. 286, amplifying Rev. Rul. 56-270, and stating that if the surviving spouse is to receive a fraction or percentage of the residue of the testator's estate — so that she shares in the appreciation or depreciation in the assets between the date of death and the date of distribution — the bequest does not provide for a fixed and definite "dollar amount," with the result that gain or loss is not realized by the estate. If there has been a net appreciation in the value of the estate, however, the value of the assets received by the surviving spouse under such a fraction-of-the-residue clause will be greater than necessary to achieve the maximum marital deduction, and the excess will swell the surviving spouse's potential estate tax. The clause that evoked Rev. Proc. 64-19, under which the executor is authorized to satisfy a marital bequest with assets at their estate tax basis, was designed to avoid the realization of gain by the estate on the distribution, but to give the surviving spouse the minimum amount consistent with a maximum marital deduction for the husband's estate. Are these mutually inconsistent aims?

If the estate realizes gain or loss because the assets are distributed in discharge of a "dollar amount" bequest, what is the income tax basis of the assets in the hands of the surviving spouse or the trustee of the marital deduction trust?

Matter of GILMOUR
18 A.D.2d 154 (N.Y. 3d Dept. 1963)

HERLIHY, J. The children of the decedent appealed from the method adopted by the Surrogate in computing the amount of the marital deduction trust. . . .

It is apparent, as will hereinafter appear, that the decedent, in drafting his will, was so intent on taking full advantage of the maximum marital Federal tax deductions that he failed to comprehend the possible inequities which might and did result therefrom.

I. As to the method of computing the marital deduction, paragraph "Three" of the will, so far as pertinent, provides:

". . . [A]n *amount* equal to the difference between: (a) One-half (½) of the value of my adjusted gross estate; and (b) the value of all property passing to my said wife under any other article or articles of this, my Will, or otherwise, and with respect to which a marital deduction is allowable to my estate under the provisions of the United States Internal Revenue Code, Section 2056; . . . As used in this article of my Will:

"(a) 'My adjusted gross estate' means my adjusted gross estate as defined in Section 2056 of the Internal Revenue Code (or in such other statutory provision as shall correspond thereto at the time of my death);

"(b) The references to 'the value of my adjusted gross estate' and to 'the value of property passing to my said wife' mean, in each case, the value thereof as *finally* determined for the purpose of fixing the Federal Estate Tax on my estate; and,

"(c) 'Marital deduction' means the marital deduction provided for in said Section 2056.

"It is my *intention* to obtain the maximum marital deduction allowable to my estate under the provisions of Section 2056, and the provisions of this, my Will, shall be construed so as to give full effect to my said intention." (Emphasis supplied.)

The Surrogate followed this language precisely and decided that as *finally determined* by the Federal tax authorities, the *adjusted gross estate* amounted to $1,036,959.16 and that the fixed amount of the *maximum marital deduction* was $518,479.58 (one half of the adjusted gross estate). There was deducted therefrom $32,000, assets passing outside of the trust to the widow and not pertinent to the issues herein. After deduction of the amount payable to the marital trust and the payment of all other charges, there remained a balance of $99,090.18 which constituted the *rest, residue and remainder* of the decedent's estate for the establishment of separate trusts for his two children.

This apparently inequitable result was due to the following adjustments made by the Internal Revenue Service at the time of the final audit fixing the Federal estate tax:

(a) The decedent within three years prior to his death made transfers to his children valued at $155,883.12, and upon audit of the estate tax return, the transfers were found to have been made in contemplation of death, and accordingly that amount was added to the gross estate as computed by the executors and the adjusted gross estate for tax purposes was enlarged by that amount.

(b) From the total amount claimed for funeral and administration expenses there was disallowed $80,618.91.

(c) Under the schedule of debts of the decedent [$628,756.23], which included personal income tax assessments, the Internal Revenue Service disallowed therefrom the sum of $183,509.75 * as it did not appear "from the evidence on file that they represented obligations incurred for an adequate and full consideration in money or money's worth."

These figures total $420,011.78, which together with other charges, not necessary to be enumerated, account for the substantial variation between the amount of the marital deduction trust fund and the residuary amount for the establishment of the children's trusts.

While it might be argued that these tax allowances and charges were not anticipated and ordinarily not to be expected, where a testator elects to use a definitive tax formula as the dispositive control for the distribution of the assets of his estate, he assumes whatever inherent risk may attach to the strict interpretation given to his intended and elected formula.

In the interpretation of a will, the intention of the testator, as gathered from the language of the will, is, of course, controlling. (Bigelow v. Percival, 162 App. Div. 831.) The fact that events happened subsequent to the probate of a will which were not foreseen by the testator cannot change the meaning of the language used. "When the purpose of a testator is reasonably clear by reading his words in their natural and common sense, the courts have not the right to annul or pervert that purpose upon the ground that a consequence of it might not have been thought of or intended by him." (Matter of Tamargo, 220 N.Y. 225, 228.) "[W]e cannot make a new will or build up a scheme for the purpose of carrying out what might be thought was or would be in accordance with his wishes." (Tilden v. Green, 130 N.Y. 29, 51.)

Matter of Inman (22 Misc. 2d 573) is strikingly similar to this case where the

* The reason for the federal disallowance of $80,618 of administration expenses and $183,509 of debts is not set out in the record, but these amounts were evidently treated as liabilities of the estate by the executor despite the Internal Revenue Service's refusal to allow them to be deducted in computing the estate tax liability. —Ed.

testator therein directed that the marital trust be based upon the "adjusted gross estate." The Surrogate decided that the trust in the will had to be given the operative effect that the testator intended, namely, that the marital trust be fixed in an amount equal to one half of the adjusted gross estate determined for tax purposes.

The executors rely upon Matter of Walsh (14 Misc. 2d 1012, affd. 8 A.D.2d 831) where the value of the gifts were deducted from the trust, but the distinguishing feature in that case is that the inter vivos gifts were made to the wife and not, as here, to the children.

Here, the testator probably did not foresee that the *finally determined* adjusted gross estate would be so inflated but his resorting to such drastic and unequivocal language in expressing his *intention* to obtain the *maximum marital deduction* prevents the granting of any relief.

II. The expenses of maintenance of the house, as provided in paragraph "Eight" of the will, should be charged to income rather than principal assets.

Paragraph "Eight" of the will provided that the widow might remain in the house for "two (2) years, without any rent or charge for occupancy, and that all taxes, assessments . . . and normal upkeep . . . shall be borne by my estate . . . and not charged specifically against the interest which I have given to my said wife."

The Surrogate decided it was the intention of the testator that these expenses should be charged to principal rather than income. The general rule provides that carrying charges on nonproductive real property are payable from income in the absence of a contrary intent in the will. (Matter of Albertson, 113 N.Y. 434, 439; Spencer v. Spencer, 219 N.Y. 459, 465; Matter of Satterwhite, 262 N.Y. 339; Matter of Kazanjian, 53 N.Y.S.2d 275.)

From a reading of the present will, it is apparent that the intention of the testator was not contrary to the general rule and accordingly we determine that the expenses of maintenance (approximately $9,449.08) should be charged to income assets. . . .

NOTE

1. *Formula clauses.* The marital deduction can equal, but it cannot exceed, 50 per cent of the adjusted gross estate. §2056(c)(1). If the entire adjusted gross estate goes to the wife, the husband's estate is sure to get the maximum marital deduction. But his wife's estate, on her death, may then be needlessly large; if she lives on the income alone, 50 per cent of the husband's property will have been taxed on his death and 100 per cent on her death. Partial protection against two taxes in rapid succession can be obtained by providing that the wife will take nothing if she dies either in a common disaster with her husband or from any cause within 6 months after his death. If she does die in a common disaster or within 6 months, the husband's estate will be taxed on 100 per cent of his property (since no property passes to the wife, no marital deduction is allowable), but there will be no tax on the wife's death. On the other hand, if the wife does not die in a common disaster or within 6 months of her husband, the interest passing to her qualifies for the marital deduction; §2056(b)(3) saves it from the the category of "terminable interest." But then the family will be subjected, as indicated above, to two taxes, one on 50 per cent, and the second on 100 per cent, of the husband's property.*

If the husband's entire gross estate passes under his will, a bequest of one half to

* If the wife dies within 10 years of her husband's death, her estate will be entitled to a credit under §2013 for part or all of the estate tax paid by his estate on the property that exceeded the marital deduction, but the credit will be less than the amount paid by the husband's estate if the wife survives her husband by more than 2 years.

his wife (outright or in the form of a life interest with power of appointment) will insure the maximum marital deduction. The other half can be left to the children, to the wife for life with remainders to the children, to the wife for life with a non-general power of appointment, or by some other disposition that will not bring it into her estate. Thus, only the one half that qualifies for a marital deduction in the husband's estate will be includible in the wife's estate on her death.

If the husband's gross estate includes non-probate property (e.g., insurance proceeds payable to designated beneficiaries, jointly held property, gifts in contemplation of death, inter vivos trusts, etc.), it is more difficult to insure that the estate will obtain the maximum marital deduction without needlessly increasing the potential tax on the wife's death. If the inter vivos transfers were to persons other than the wife, she must get more than one half of the probate property, if full advantage is to be taken of the marital deduction. If the transfers outside the will were to the wife, however, she must get less than one half of the probate property lest her estate be unnecessarily increased. A proposed "formula clause" to give the wife an amount which will insure the maximum marital deduction, but no more, provides as follows:

> If my wife survives me, I devise and bequeath to her a portion of my estate the value of which shall be exactly the sum needed to obtain the maximum marital deduction in determining the Federal estate tax on my estate after taking into account all the other items of my gross estate (whether passing under this Will or otherwise) that qualify for said deduction.

In the early days of the marital deduction, some commentators speculated that a formula clause of this type might be held invalid as improperly incorporating by reference a document (the Internal Revenue Code) that might be changed after the will was executed. Others suggested that the rule against perpetuities might be violated, since the estate tax values, which control the amount of the bequest, will not necessarily be ascertained during the perpetuities period. These fears have proved to be unfounded, if for no other reason than judicial reluctance to upset a testamentary pattern that is now widely used. See also Braun v. Central Trust Co., 104 N.E.2d 480 (Ohio, 1951), rejecting the argument that a formula clause violates the rule against perpetuities; Conn. Gen. Stats. §45-174, providing that wills may refer to federal statutes or regulations governing the marital deduction as a means of computing the amount of a bequest.

Even though formula clauses are valid, they may create difficult problems of administration for the executor. Consider the effect of an inter vivos gift to a child that the government asserts was made in contemplation of death. If it is included in the gross estate, the formula clause will increase the surviving spouse's share of the probate estate. Must the executor resist the government's claim with especial vigor lest the heirs claim he is favoring the wife? Because of the gift tax credit of §2012, it is possible that inclusion of such a gift will not increase the estate tax. If so, could the executor properly spend funds of the estate to litigate the contemplation of death issue because of its effect on the substantive rights of the legatees? If the inter vivos transfer in question was a gift to the surviving spouse rather than to a child, how will the formula clause affect the executor, the surviving spouse, the other heirs, and the tax collector? The executor may find the formula clause troublesome at other points as well, e.g., in deciding whether to employ the optional valuation date of §2032 or to take deductions on the income tax return instead of on the estate tax return, supra page 1273, since his decisions on these matters may affect the size of the surviving spouse's share under the formula clause. See In re Inman, 22 Misc. 2d 573 (N.Y. 1959) (effect of election to deduct administration expenses on income tax return on marital bequest).

2. *Widow's disclaimer in estate planning.* As an alternative to a formula clause, is it feasible for the testator to leave his entire probate estate to his wife outright, and for her to disclaim whatever amount is not needed to insure the maximum marital deduction for her husband's estate? (This plan assumes that the husband is willing for the widow to take everything if she wishes.) The purpose of the disclaimer, if made, would be to avoid a needlessly large tax on her estate; and the amount disclaimed could be computed

so as to produce either the lowest *aggregate* tax on the two estates or the lowest possible tax on her husband's estate. See page 1270 supra for the possibility of a gift tax on the disclaimer.

Note that if the widow receives "too much" from her husband's estate, she can diminish her own potential estate tax by inter vivos gifts (taking advantage of the annual exclusion and the specific exemption, if not previously exhausted) during the period after her husband's death.

3. *Is the maximum marital deduction always advantageous?* It is sometimes assumed that if the husband leaves the wife enough to insure that his estate will get the maximum marital deduction and leaves everything else in such a form that it will not be included in her estate, the lowest possible aggregate estate taxes will result. Indeed, there are tables, formulas, and even a handy slide rule to compute in dollars the tax savings that such a disposition will produce, as against leaving everything to the wife outright or leaving her less than enough to secure the maximum marital deduction. But *will* the tax savings necessarily be realized? What if tax rates change? What if there are wide fluctuations in property values? What if the wife does not use all of the income from the property left to her and reinvests the unconsumed portion? How are the calculations affected by the wife's own property?

4. *The surviving husband.* In our society, the husband typically owns most of the family property and dies before his wife. If the first spouse to die owns little or no property, however, the marital deduction will be correspondingly small — or nonexistent. In such cases, the 1948 estate tax legislation failed to produce equality between community property and common law property states. Is there a do-it-yourself remedy for the married couple in a common law property jurisdiction? Consider the estate and gift tax consequences of an inter vivos division of their property.

Should there be *any* tax on transfers of property, either inter vivos or at death, between husband and wife? See DeWind, The Approaching Crisis in Federal Estate and Gift Taxation, 38 Calif. L. Rev. 79, 109-116 (1950).

5. *Charitable gifts to increase the marital deduction?* In an article entitled Personal Finance: How to Save By Giving (N.Y. Times, Oct. 7, 1963, p. 48), the following plan for increasing the taxpayer's potential marital deduction by making an inter vivos charitable contribution is described:

> The greatest tax advantage of charitable giving through life insurance is to high-income or wealthy people, especially in the area of estate taxation. For example, a man leaving a $1,000,000 estate might save his heirs as much as $70,000 in Federal estate taxes by directing some of his charitable giving to the purchase of a $500,000 policy for the benefit of his favorite charity. The premium payments of course, would be immediately tax deductible.
>
> In buying the policy, he would name the recipient institution irrevocable beneficiary and possibly owner of the policy. However, he would retain what is legally referred to as an "incident of ownership," such as the right to determine the settlement option by which the beneficiary would receive the proceeds. That incident of ownership allows the inclusion of the proceeds of the policy in his total estate, thus increasing it from $1,000,000 to $1,500,000.
>
> In the case of a $1,000,000 estate, the adjusted gross estate, after deduction of perhaps $100,000 in expenses, would be $900,000. The wife would be entitled to half of that, tax free. An additional $60,000 personal deduction for the deceased would leave a taxable balance of $390,000. The Federal estate tax on that amount, not considering any credit for state-tax payments, would be $91,300.
>
> In the case of the $1,500,000 estate, including the $500,000 charitable policy, the adjusted gross estate would be $1,400,000, allowing the same $100,000 in expenses. The wife would be allowed a tax-free half of that, or $700,000. Of the balance, $500,000 — the proceeds of the policy — would go tax-free, to the church, hospital or other institution named, leaving $200,000, from which the deceased's personal deduction of $60,000 is made. The remainder of $160,000 would be the taxable balance on which a Federal estate tax payment of $20,800 would be due.

If this plan were to be described with the same care that goes, or should go, into the drafting of an SEC registration statement, what more would have to be said so that what was said would not be misleading?

6. *Income tax basis of marital deduction property.* The surviving spouse's income tax basis for inherited property is its date-of-death (or optional valuation date) value by virtue of §1014, even though it qualified for a marital deduction. For the parallel rule applicable to the wife's share of community property, see §1014(b)(6).

7. *References.* Stevens, Fourteen Years of Marital Deduction, 21 N.Y.U. Inst. on Fed. Taxation 257 (1963); Trachtman, Estate Planning (P.L.I. 1964) 12-66, 97-105; Estate Planning and the Marital Deduction (Report of Subcommittee of A.B.A. Committee on Estate and Tax Planning), 102 Trusts & Estates 934 (1963), and references there cited; Halbach, Post-Mortem Estate Planning, 1963 U. of Ill. L.F. 212; Molloy and Woodford, Estate Planning Techniques and the Ownership of Canadian Securities, 62 Yale L.J. 147 (1953).

SMITH'S ESTATE v. COMMISSIONER

23 T.C. 367 (1954)

LEMIRE, Judge: The respondent determined a deficiency in gift taxes for the year 1948 in the amount of $604.92.

The issue for determination is whether decedent is entitled to a marital deduction with respect to the sum of $5,041 which he paid to insurance companies as premiums on life insurance policies on his life which he had transferred in trust. . . .

On November 23, 1934, the decedent created a trust by deed. The provisions of the trust instrument, material here, read as follows:

I, CHARLES C. SMITH, at Philadelphia, Pennsylvania, hereby irrevocably assign and deliver to PROVIDENT TRUST COMPANY OF PHILADELPHIA, and its Successors, the Life insurance policies set forth in the Schedule hereto annexed, In Trust, for the following uses and purposes:

FIRST: Trust Provisions: Trustee shall collect and receive all sums payable to or expended on behalf of such beneficiary by Trustee, in such manner as shall hold and apply said sums and the net income therefrom in accordance with the following terms and provisions:

(a) [This paragraph provided certain benefits for the settlor's mother-in-law, which were nullified by her death in 1938, prior to the taxable year in dispute.]

(b) Subject to the provisions of paragraph (a) of this First Section, Trustee shall hold the principal of said Trust and shall pay the net income therefrom to my wife, Frances Hayward Smith, for her life. Trustee shall also pay to my wife such sums out of the principal held under this paragraph (b) as she may from time to time in writing request Trustee to pay to her; provided, however, that such payments to my wife out of principal under the terms of this paragraph (b) shall not exceed in the aggregate Twenty-five thousand Dollars. I authorize Trustee also to pay to my wife, or expend for her benefit, such sums out of the principal held under this paragraph (b) as Trustee may from time to time deem necessary for her proper comfort and support.

At the decease of my wife, Frances Hayward Smith, Trustee shall distribute the principal then held under this paragraph (b) to such persons and in such manner and shares and for such estates or upon such trusts as my said wife may have directed and appointed by her last Will; and in default of such direction and appointment, then to the persons who would have been entitled thereto, under the then existing Intestate Laws of the State of Pennsylvania, had I died intestate, at that time, seized and possessed thereof. . . .

THIRD: Principal Expenditures: Trustee may expend out of the share of principal from which any beneficiary under this Deed may be receiving income such sums as Trustee may consider to be for the best interest of such beneficiary, during illness or emergency of any kind.

FOURTH: Right in Trustee to Borrow on Policies: I authorize Trustee during my

lifetime, if in the opinion of Trustee, in its sole discretion, it would be advisable so to do, to borrow on any policy or policies of insurance held hereunder, for the purpose of raising funds for any beneficiary hereunder who in the opinion of Trustee may be in need of such funds: the amounts so borrowed to be paid to or expended on behalf of such beneficiary by Trustee, in such manner as Trustee in its sole discretion may determine. . . .

THIRTEENTH: Settlor's Relinquishment of Rights under Policies: [By this clause the taxpayer relinquished the incidents of ownership of the insurance policies.]

After the execution of the trust deed the decedent assigned certain life insurance policies on his life to the trustee.

From the date the trust was created to December 1948, the corpus of the trust consisted only of the life insurance policies, and the trust never realized any distributable income. . . .

Charles C. Smith, the settlor of the trust, died testate on August 7, 1954.

The petitioners [the settlor's executors] claim a marital deduction in computing net gifts for the year 1948 with respect to insurance premiums paid on the life insurance policies transferred to the trust. The applicable provision involved is [§2523(e)]. This section allows a marital deduction for gifts to a trust for the benefit of the donor's surviving spouse, if the beneficiary is entitled to all the income from the corpus of the trust for life, payable annually or at more frequent intervals, with the power in the donee spouse to appoint the corpus free of the trust to herself or her estate.

The petitioners contend that the trust instrument meets the requirements of the statute and that the regulations prescribed by the respondent relative to the payment of income are invalid. Regs. [§25.2523(e)-1(f)]. The regulations are rather extensive and we will refer only to that part material to the narrow issue presented.

At the time of the transfers in question the corpus of the trust consisted solely of insurance policies on the life of the settlor spouse. The settlor knew and intended that the trust would not provide any economic benefits until his death would bring into the trust the proceeds of the policies. Then, and only then, would the trust have unrestricted property which would produce an income for his wife.

The regulations material here provide that the beneficiary must be the virtual owner of the property during her life. The regulations further provide:

(4) Provisions granting administrative powers to the trustees will not have the effect of disqualifying an interest transferred in trust unless the grant of powers evidences the intention to deprive the donee spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations will not disqualify the interest transferred in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus, the power to apply the income or corpus for the benefit of the spouse, and the power to retain the assets transferred to the trust. For example, a power to retain trust assets which consist substantially of unproductive property will not disqualify the interest if the applicable rules for the administration of the trust require, or permit the spouse to require, that the trustee either make the property productive or convert it within a reasonable time. Nor will such a power disqualify the interest if the applicable rules for administration of the trust require the trustee to use the degree of judgment and care in the exercise of the power which a prudent man would use if he were owner of the trust assets. Further, a power to retain a residence for the spouse or other property for the personal use of the spouse will not disqualify the interest transferred in trust.

(5) An interest transferred in trust will not satisfy the condition set forth in paragraph

(a)(1) of this section that the donee spouse be entitled to all the income if the primary purpose of the trust is to safeguard property without providing the spouse with the required beneficial enjoyment. Such trusts include not only trusts which expressly provide for the accumulation of the income but also trusts which indirectly accomplish a similar purpose. For example, assume that the corpus of a trust consists substantially of property which is not likely to be income producing during the life of the donee spouse and that the spouse cannot compel the trustee to convert or otherwise deal with the property as described in subparagraph (4) of this paragraph. An interest transferred to such a trust will not qualify unless the applicable rules for the administration require, or permit the spouse to require, that the trustee provide the required beneficial enjoyment, such as by payments to the spouse out of other assets of the trust.*

The petitioners rely on subparagraph (b) of paragraph FIRST of the trust deed which provides that "Subject to the provisions of paragraph (a) of this First Section, Trustee shall hold the principal of said Trust and shall pay the net income therefrom to my wife, Frances Hayward Smith, for her life."

There is no provision in the trust deed giving the settlor's wife the right to compel the trustee to convert the insurance policies into income-producing property.

The tenor of the trust deed is that it was the settlor's intention to have the policies retained by the trustee until his death, and to have such income as was received by way of dividends on the policies devoted to their preservation.

The direction contained in subparagraph (b) of the trust deed's paragraph FIRST, respecting the payment of income, was without any substance and impossible of fulfillment, because the entire corpus was of non-income-producing property. Jesse S. Phillips, 12 T.C. 216, 223; Commissioner v. Boeing, 123 F.2d 86.

Treasury regulations are ordinarily valid unless unreasonable or inconsistent with the statute. Fawcus Mach. Co. v. United States, 282 U.S. 375; Commissioner v. Wheeler, 324 U.S. 542. If not unreasonable or plainly inconsistent with the statute they should not be overruled except for weighty reasons. Commissioner v. South Texas Lumber Co., 333 U.S. 496, 501. We think the regulations here involved in no way extend the statute but rather follow both the letter and spirit of the law. We hold that they are valid.

Accordingly, we sustain the respondent's disallowance of the marital deduction claimed with respect to the gifts of insurance premiums made in the tax year 1948.

KASS v. COMMISSIONER

¶57,227 P-H Memo T.C.

TRAIN, Judge:

Respondent determined a deficiency of $1,620 in the gift tax of the petitioner for the year 1952. The only issue is whether the interests of third parties under a certain gift in trust of which petitioner's spouse is the life beneficiary were "ascertainable at the time of the gift, and hence severable from the interest transferred to his spouse," as provided by Treasury Regulations [§25.2513-1(b)(4)], so that petitioner is entitled to the gift-splitting benefits of [§2513].

All the facts have been stipulated and are hereby found as stipulated.

The petitioner is an individual and a resident of New York. On January 5, 1952, the petitioner made a gift in trust of 5,000 Class A shares of Universal Leather Goods, Ltd., a British corporation, in accordance with a trust instrument

* Current Regs. §25.2523(e)-1(f)(4) and (5) have been substituted for the earlier Regulations quoted by the court. — ED.

executed on the same day. The 5,000 shares had a value of $54,000 at the time of the transfer.

On March 15, 1953, the petitioner filed a timely gift tax return with the district director for the third district of New York, reporting the above gift and, with her consent, splitting the gift with his wife Marie Kass. On the same day, she filed a gift tax return reporting one-half of the gift.

Both the petitioner and his wife are citizens and residents of the United States and were such on January 5, 1952. Marie Kass was 70 years old on January 5, 1952. On January 1, 1952, she was the owner of securities, independent of the trust, with a total market value of approximately $132,000. During the years 1951 through 1954, Marie Kass reported for Federal income tax purposes the following income from dividends, which does not include the income distributed to her under the trust in question:

1951	$6,100.61
1952	4,746.69
1953	6,531.94
1954	7,177.03

During the years 1952, 1953, 1954, and 1955, Marie Kass reported on her joint Federal income tax return filed together with the petitioner the following net income (after British taxes) from distributions under the trust in question:

1952	None
1953	$9,236.77
1954	3,732.32
1955	3,953.56

No invasion or distribution of the trust corpus has occurred since the creation of the trust. The trustees do and continue to hold in trust the original 5,000 shares of stock.

The trust instrument provided that the net income should be paid to Marie Kass for life. Upon her death, it was provided that the trust should be divided into three equal trusts, each of which had income beneficiaries and remainders over. The trust instrument provided further:

> THIRD: The Trustees, in their absolute discretion, shall have the power to pay from time to time, out of the principal of any Trust, such sum or sums to any income beneficiary of such Trust as the Trustees may deem necessary or advisable for the general welfare of such beneficiary. In the exercise of this power, the Trustees may, in their discretion, exhaust the principal of any Trust, in which case, such Trust shall terminate.

The petitioner contends that "general welfare" in "Third" of the trust instrument provides a fixed standard limiting the power to invade the principal, and that, in light of the facts, the probability of exercise of the power is so low as to be negligible. The respondent maintains that no such standard is provided and that, even if "general welfare" provides a sufficient standard of limitation, the facts are not sufficient to enable one to ascertain the probability of the exercise of the power. In short, the respondent contends that the interests of third parties were not ascertainable at the time of the gift. Regulations [§25.2513-1(b)(4)].

On the record before us, we must sustain the respondent's position.

We shall assume, without deciding, that the term "general welfare" is equivalent to a provision for maintaining the income beneficiary according to her usual standard of living. See Blodget v. Delaney, 201 F.2d 589 (C.A. 1, 1953); In re Mayer's Will, 59 N.Y.S.2d 558 (1945); Commissioner v. Robertson's Estate, 141 F.2d 855 (C.A. 4, 1944), affirming a memorandum opinion of this Court dated

September 12, 1942. However, the remoteness of the possibility of the power being exercised is a matter of practicability and depends upon the factual circumstances as well as the language limiting the power. William H. Robertson, 26 T.C. 246 (1956); Commissioner v. Robertson's Estate, supra; Commissioner v. Wells Fargo Bank & Union Trust Co., 145 F.2d 130 (C.A. 9, 1944), affirming a memorandum opinion of this Court dated May 20, 1943.

Petitioner has introduced no evidence of whether Marie Kass was supported by her husband and, if that is the case, his annual income. Likewise, the record is void of any evidence of Marie's annual living expenses. Nor does the record show whether she lived frugally or extravagantly. We know that she owned securities worth about $132,000 at the time of the gift, and we also know the amount of her annual income from dividends and from the trust. Finally, we know her age. Although relevant, these facts are here without any helpful significance in the absence of evidence as to her normal standard of living. Resources which might be more than adequate in the circumstances of one individual may be totally inadequate in those of another. The only evidence tending to show that her income was adequate is the fact that the trust principal has not been invaded for her benefit, but this fact was not ascertainable at the time of the gift. Regulations [§25.2513-1(b)(4)]; cf. Regulations [§20.2055-2(a)]; William H. Robertson, supra; Estate of Charles H. Wiggin, 3 T.C. 464 (1944); Commissioner v. Wells Fargo Bank & Trust Co., supra; Ithaca Trust Co., 279 U.S. 151 (1929), reversing 64 Ct. Cls. 686 (1928). But cf. Estate of Horace G. Wetherill, 4 T.C. 678 (1945). As in Andrew Geller, 9 T.C. 484 (1947), the taxpayer in the instant case has failed to prove sufficient facts by which to measure the probability of the exercise of the power.

The cases relied upon by the petitioner are distinguishable in that further facts were found in those cases not present here which were necessary to prove the remoteness of the possibility of invasion. See Ithaca Trust Co., supra; William H. Robertson, supra; Commissioner v. Robertson's Estate, supra; Estate of Horace G. Wetherill, supra.

Petitioner has conceded the only other issue, involving the disallowance of the annual gift exclusion of $3,000.

NOTE

Implications of Kass case. Was taxpayer entitled to a marital deduction in respect of the transfer? What would have been the result if he had given his wife 2500 shares of the stock in question, and they had then joined in the creation of a trust with terms identical with those in the disputed trust?

Would the result in the case have been different if the taxpayer had proved that the likelihood of the taxpayer's wife needing any of the principal was extremely slight?

Does *Holtz' Estate* (supra p. 1013) shed any light on the proper treatment of the trust in Kass v. Commissioner?

SECTION F. CREDITS AGAINST THE TAX

After the estate tax has been computed by applying the rates set out in §2001 to the "taxable estate," certain credits are computed and deducted. These credits are allowed for (1) state death taxes paid with respect to property included in the gross estate (§2011), (2) death taxes paid to a foreign country in respect of property situated in that country and included in the gross estate (§2014), (3) federal gift taxes paid on an inter vivos transfer of property that is included in the gross estate (§2012), and (4) federal estate taxes paid by another decedent with respect

to property transferred by him to the current decedent if the former died within the 12-year period beginning ten years before the latter's death and ending two years after his death.

1. *Credit for State Death Taxes: §2011*

ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS, REPORT ON COORDINATION OF STATE AND FEDERAL INHERITANCE, ESTATE AND GIFT TAXES

32-35 (1961)

The dominant factor in death taxation in the United States is the Federal estate tax. The present tax dates from 1916, but the National Government has levied death taxes of various types intermittently since 1798 (1798 to 1802; 1861 to 1870; 1898 to 1902). Unlike the previous inheritance taxes of both the National Government and the States, the 1916 Federal tax was imposed on the transfer of the entire estate rather than on the separate amount going to each beneficiary.

When the National Government enacted its present estate tax, State death taxation already had a long history. Pennsylvania led off in this field in 1825 with an inheritance tax on collateral heirs. Several States followed Pennsylvania's example with taxes on direct, as well as collateral, heirs. These early enactments fell into disuse after the Civil War, and by 1885 only two or three States were making effective use of them. The imposition of a 5 percent tax on collateral heirs by New York in 1885 marked the revival of State interest in this tax field and in 1903 Wisconsin pioneered graduated rates on transfers to direct and collateral heirs with a comprehensive definition of taxable property and a centralized State tax administration. By 1916 all but five States had adopted some form of inheritance tax and spokesmen for the States regarded the taxation of bequests their special tax preserve.

The enactment of the Federal estate tax in 1916 focused attention on Federal-State tax relations which by then had been under discussion for some time. Nearly 10 years earlier, spokesmen for the States strongly opposed President Theodore Roosevelt's proposal for a Federal inheritance tax.* They urged that death duties be considered State rather than Federal sources of revenue, among other reasons because some States had relied upon this source of revenue for almost a century.

The enactment of the Federal estate tax, and more particularly its retention after the First World War, rekindled State opposition to the Federal levy and culminated in two conferences on inheritance and estate taxation held in 1925 under the auspices of the National Tax Association. In the meanwhile a 25 percent Federal credit for State taxes had been introduced in 1924. These conferences resolved that the Federal Government should withdraw from the field of death taxation within 6 years and in the interim should allow taxpayers an 80 percent credit against Federal tax liability for taxes paid to States. There were some, however, who opposed repeal of the Federal tax. They feared that competitive tax reduction among the States to attract wealthy residents would quickly dissipate this tax area as a source of State revenue.† (In 1924 Florida had amended

* Supra page 989. — Ed.

† See Perkins, State Action Under the Federal Estate Tax Credit Clause, 13 N.C.L. Rev. 270 (1935): "In the spring of 1925 the Alabama Power Company proclaimed the opportunities of the

its constitution prohibiting inheritance taxation with a view to attracting residents from other States.) They wanted some Federal tax continued on a permanent basis together with the tax credit. This, in fact, was the solution adopted by the Congress in 1926 when it reduced tax rates, raised the exemption and increased the credit to 80 percent of Federal tax liability. The 1926 legislation was interpreted as a willingness on the part of the Federal Government to share death tax revenues with States on a permanent basis in the ratio of 1 to 4.

The Federal tax credit served a double purpose. It provided tax reduction, an objective of Federal tax policy in the 1920s. By allowing a credit for State taxes, it reduced the combined Federal-State tax burden. . . .

Introduction of the tax credit, moreover, fixed a floor under State death taxes in order to deter interstate competition for wealthy residents. This had the effect of enabling the States, through appropriate legislation, to impose death taxes as high as 80 percent of the Federal tax liability without adding to the net tax burden of their taxpayers. Within this limit, States could reserve for themselves tax revenue which otherwise would go to the Federal Government. A third objective, uniformity among State taxes, was not achieved partly because some State taxes already exceeded the credit.

After 1926 some of the States made an attempt to bring their death tax structure into conformity with that of the National Government. Some replaced old statutes with new enactments correlated with Federal law. Others, including New York, shifted to the estate tax type duty. Most States amended their laws to insure full utilization of the credit. The exception was Nevada. It repealed its inheritance tax in 1925 and, for many years, has been the only State not imposing a death tax. . . .

While some States were moving toward the Federal-State tax pattern visualized by the credit arrangement, the need for additional revenues moved the National Government away from that pattern.

In 1932 the Congress enacted higher estate tax rates but retained the rates under the basic 1926 tax for purposes of determining the maximum credit for State taxes. Federal rates were increased again in 1934, 1935, and 1941. A temporary 10 percent defense surtax was in effect from June 26, 1940, through September 20, 1941. Since 1941 Federal estate tax rates have remained unchanged. They range from 3 percent on the first $5,000 to 77 percent on that portion of taxable estates in excess of $10 million.

The estate tax specific exemption, which had been $100,000 under the basic 1926 tax, was reduced to $50,000 in 1932 and to $40,000 in 1935. In 1942 the

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state whose name it carries by a series of advertisements of this nature: 'Who Gets Your Estate When You Die? That all Depends on Where You Live, What You Own and Where You Die. Taxation Figures of the H. C. Frick Estate as Published in the "Nation's Business" are a striking example: Federal Tax, $6,338,898.68; Pennsylvania State Inheritance Tax, $3,167,197.87; Other Inheritance Taxes, $1,546,565.49. If the H. C. Frick estate had been in Alabama and the testator had been a resident of Alabama, his state inheritance tax would have been Nothing!' Another advertisement in the series thus explained to the prospective decedent this elysian state of affairs: 'No Inheritance Tax Under Alabama Constitution. Not only has Alabama no Income nor Inheritance Tax but the framers of the Alabama Constitution have gone so far as to make sure that No Inheritance Tax Can Be Levied by the Alabama legislature on estates left to lineal descendants. Alabama is the Only State of Industrial Vantage Which Has Neither Income Nor Inheritance Tax. Profits Made in Alabama Pass to Heirs!'

"In the fall of the preceding year Florida amended her constitution in order to prohibit the taxation of inheritances and the taxation of incomes of residents of that state. . . . Such an amendment with its necessarily attendant publicity appeared to be an advertisement that Florida would be a permanent refuge from inheritance taxation. The legislature of Nevada in February 1925 followed up this procedure by repealing that state's inheritance tax act of twelve years' standing." — ED.

$40,000 specific exemption and a $30,000 insurance exclusion were combined into a $60,000 specific exemption. These post-1926 tax rate increases and exemption reductions provided no increase in the credit through which States might have shared in the additional revenue. On the contrary, the marital deduction for property passing to the surviving spouse, introduced in 1948, significantly reduced the amount of taxable property and Federal tax liabilities, thereby reducing the credit allowed for State taxes. The cumulative effect of these post-1926 changes is evident from Table 2.

TABLE 2. — *Credit for State Taxes in Relation to Gross Federal Estate Tax Liability*[1] *Under 1926 Act and Present Law*

	1926 Act			Present law					
		Tax credit		Single decedent			Decedent with surviving spouse[2]		
					Tax credit			Tax credit	
Net estate before specific exemption	Gross Federal tax	Amount	Percent of Federal tax	Gross Federal tax	Amount	Percent of Federal tax	Gross Federal tax	Amount	Percent of Federal tax
$100,000	0	0	—	$4,800	0	—	0	0	—
$150,000	$500	$400	80	17,900	$400	2.2	$1,050	0	—
$250,000	3,000	2,400	80	47,700	2,400	5.0	10,900	$200	1.8
$500,000	12,500	10,000	80	126,500	10,000	7.9	47,700	2,400	5.0
$1,000,000	41,500	33,200	80	303,500	33,200	10.9	126,500	10,000	7.9
$5,000,000	489,500	391,600	80	2,430,400	391,600	16.1	968,800	138,800	14.3
$10,000,000	1,334,500	1,067,600	80	6,042,600	1,067,600	17.7	2,430,400	391,600	16.1
$25,000,000	4,333,500	3,466,800	80	17,592,000	3,466,800	19.7	7,967,000	1,466,800	18.4

1 Gross Federal tax liability is before all tax credits. Present law rates are those provided in the Internal Revenue Code of 1954, originally enacted in 1941.

2 It is assumed that one-half of the estate is left to the spouse.

Another factor in altering the Federal-State death tax pattern contemplated in 1926 was the introduction of the Federal gift tax [which] . . . was deliberately designed to encourage the distribution of estates during the lifetime of the owners. To the extent property is distributed during life, the size of the estate subject to Federal and State death taxes is of course reduced. The gift tax allows no credit for taxes paid to the States. . . .

The impact of these developments on the States' share of death tax revenues is reflected in the tax collection statistics contained in Table 1 [omitted]. Thirty years ago State and local governments collected about three-fourths of all death taxes collected by all governments; the National Government about one-fourth. This relationship has now been reversed. The National Government's share is now about 80 percent; the State and local share about 20 percent.

In their efforts to preserve their share of the revenue from these taxes, States resorted to the enactment of independent inheritance, estate, and gift taxes outside the Federal credit. The Federal credit continues to serve the purpose of keeping a floor under State tax liability and preventing interstate competition but has not eliminated interstate diversity. Although every State, except Nevada, now imposes a tax at least equal to the maximum Federal credit, wide interstate variations remain both in structure and tax liability.

The basic outlines of the States' taxes fall into several groups. . . . The simplest of these are the five estate taxes patterned after the Federal statute and designed to impose a tax liability equal to the maximum credit for taxes paid to the States allowed under Federal law. Some of these so-called "pick-up" taxes, originally intended to preempt for the States the exact amount of the Federal credit — nothing more or less — have actually departed in some measure from the

pure "pick-up" pattern by adopting some provisions which differ from those contained in the Internal Revenue Code. In consequence, State tax liability, even in these States, frequently exceeds the Federal credit.

Three States use only inheritance taxes; 35 States and the District of Columbia rely primarily on inheritance taxes, which they supplement with "pick-up" statutes to absorb any unused Federal credit. . . .

Estate and inheritance tax rates and exemptions vary greatly among the States. . . .

There are important interstate variations also in the structural features of State death taxes, especially in deductions allowed in determining the net estate. An important variant, for example, is the treatment of Federal estate taxes. Half of the States and the District of Columbia allow this tax to be deducted in determining the amount of the taxable estate. . . . A marital deduction for property passing to the surviving spouse is allowed in 13 States. Most limit the marital deduction to a share of the estate but some exempt all property passing to the surviving spouse or children. . . .

In 1960 State death and gift tax collections aggregated $419 million. This total excludes small amounts ($16 million in 1958) of State imposed inheritance and estate taxes retained by local jurisdictions in 10 States and the collections of the District of Columbia. Death and gift taxes supply about 2.3 percent of the States' tax revenues and about 1.1 percent of the combined tax collections of State and local governments. These averages, however, submerge substantial variations among the States. In 1960 the share of State collections supplied by these taxes ranged from less than half of 1 percent in nine States to 7.1 percent in Connecticut.

[The report goes on (pp. 55-82) to describe various alternative tax credit arrangements.]

NOTE

1. *Calculation of the credit: 80 per cent of the federal "basic" tax.* In 1926, the maximum allowable credit was fixed at 80 per cent of the federal *basic* estate tax; no credit was allowed against the federal *additional* estate tax. When the basic and additional taxes were combined into a single federal estate tax by §2001 of the 1954 Code, the maximum allowable credit for state death taxes was set out in a table, §2011(b), and a method was provided for computing a "basic estate tax" to avoid distributing state statutes which refer to this concept. §2011(d); see page 1271 supra.

2. *Constitutionality of the credit.* The constitutionality of the credit was attacked without success by the State of Florida in Florida v. Mellon, 273 U.S. 12 (1927). The Supreme Court said, among other things:

> The contention that the federal tax is not uniform, because other states impose inheritance taxes while Florida does not, is without merit. Congress cannot accommodate its legislation to the conflicting or dissimilar laws of the several states, nor control the diverse conditions to be found in the various states, which necessarily work unlike results from the enforcement of the same tax. All that the Constitution (article 1, §8, cl. 1) requires is that the law shall be uniform in the sense that by its provisions the rule of liability shall be alike in all parts of the United States.
>
> The claim of immediate injury to the state rests upon the allegation that the act will have the result of inducing potential taxpayers to withdraw property from the state, thereby diminishing the subjects upon which the state power of taxation may operate. The averment to that effect, however, affords no basis for relief, because, not only is the state's right of taxation subordinate to that of the general government, but the anticipated result is purely speculative, and, at most, only remote and indirect. Minnesota v. Northern Securities Co., 194 U.S. 48, 68, 70. If, as alleged,

the supposed withdrawal of property will diminish the revenues of the state, non constat that the deficiency cannot readily be made up by an increased rate of taxation. Plainly, there is no substance in the contention that the state has sustained, or is immediately in danger of sustaining any direct injury as the result of the enforcement of the act in question. See In re Ayers, 123 U.S. 443, 496; Massachusetts v. Mellon, 262 U.S. 447, 488.

Nor can the suit be maintained by the state because of any injury to its citizens. They are also citizens of the United States and subject to its laws. In respect of their relations with the federal government — "it is the United States, and not the state, which represents them as parens patriae, when such representation becomes appropriate; and to the former, and not to the latter, they must look for such protective measures as flow from the status." Massachusetts v. Mellon, supra, pages 485, 486. [273 U.S. at 17-18.]

An attack by an executor was equally unsuccessful in Rouse v. United States, 65 Ct. Cl. 749 (1928), cert. denied, 278 U.S. 638.

3. *Federally based state death taxes.* As indicated in the Report of the Advisory Commission on Intergovernmental Relations, state "pick-up" (or "slack") taxes are widely used to collect the difference between the state death taxes otherwise owing by the estate and the maximum amount that can be credited under §2011 against the federal estate tax liability. See, for example, California Revenue and Taxation Code §13441 (imposing additional tax equal to difference between maximum federal credit and California inheritance tax); Florida Statutes §198.02 (imposing tax on estate of resident decedents equal to difference between federal credit and death taxes actually paid to other states). Despite its purpose of merely diverting funds from the federal government to the state, the "pick-up" tax in some circumstances may actually increase the estate's aggregate tax burden. See Wells v. Gay, 58 So.2d 848 (Fla. 1952), imposing the state "pick-up tax" even though it was paid after expiration of the time for claiming the federal credit; In re Good's Estate, 28 Cal. Rptr. 378 (1963) (state "pick-up" tax due even though estate would prefer to forego the §2011 credit, in order to increase the federal estate tax payable and thereby to increase the federal gift tax credit of §2012).

The "pick-up" tax automatically adjusts itself to the federal tax structure, and requires no more than a sentence or two in the state's statute books. New York recently took the additional step of modeling its basic death tax on the federal scheme by defining the state-taxed "gross estate" in the same manner as the federal "gross estate" (after elimination of out-of-state property), carrying over the federal deductions, etc. 59 McKinney's Consolidated Laws of New York Ann., art. 26. In enforcing the new tax, New York's administrators are to hitchhike: a "final federal determination" (as defined) as to includible property, allowable deductions, and values will also determine the same issue for New York purposes unless the federal determination is shown to be erroneous by a preponderance of the evidence. Query: What "evidence" can be introduced to prove that a question of *law* was erroneously determined? See generally Miller, An Introduction to New York's Federally-Based Estate Tax Statute, 34 N.Y.S.B.J. 267 (1962).

4. *References.* Advisory Commission on Intergovernmental Relations, Report on Coordination of State and Federal Inheritance, Estate, and Gift Taxes (1961); Cogburn, The Credit Allowable Against the Basic Federal Estate Tax for Death Taxes Paid to States and State Statutes Enacted to Take Advantage Thereof — Constitutional Difficulty and Some Suggested Solutions, 30 N.C.L. Rev. 123 (1952); Groves, Retention of Estate and Gift Taxes by the Federal Government, 38 Calif. L. Rev. 28 (1950); Oakes, The Federal Offset and the American Death Tax System, 54 Q.J. Econ. 566 (1940); Groves, Gulick, and Newcomer, Federal, State, and Local Government Fiscal Relations, S. Doc. No. 69, 78th Cong., 1st Sess. 469-496 (1943); Maxwell, The Fiscal Impact of Federalism in the United States 331-353 (1946).

2. *Credit for Foreign Death Taxes: §2014*

For this credit, and the related possibility that double taxation will be avoided by an estate tax treaty, see page 1076 supra.

3. *Credit for Federal Gift Taxes: §2012*

Earlier portions of this book demonstrate how frequently property is included in the gross estate for estate tax purposes even though its transfer during the decedent's lifetime was subject to a federal gift tax. Section 2012 allows a credit against the estate tax in such circumstances, so that "the gift tax amounts in some instances to a security, a form of down-payment on the estate tax which secures the eventual payment of the latter." Smith v. Shaughnessy, supra page 1224. The first step in computing the credit is to determine the amount of gift tax paid on the gift, since this amount is one limitation (referred to as the "first limitation" in Regs. §20.2012-1) on the amount that may be credited by the decedent's estate. If the gift in question was the only gift made by the decedent in a particular year and it is fully included in the gross estate, the "first limitation" is readily applied, since the gift tax is the amount paid by the donee for that year. If the decedent made more than one gift during the year in question, however, application of the "first limitation" is more complex. The "second limitation" on the credit is that it may not exceed the estate tax attributable to inclusion of the gift in the decedent's gross estate. For some of the intricacies in the "second limitation," see Regs. §20.2012-1(d).

Although the gift tax paid may often be credited in full against the estate tax, sometimes the limitations of §2012 will permit a partial credit only. Such a loss of the part of the "down payment" may result if the decedent made extensive lifetime gifts, so that the gift tax paid on the transfer in question was greater than the estate tax attributable to it. Another possibility of a partial loss of the "down payment" arises because the credit under §2012 is computed by taking the value of the transferred property at the time of the gift or at the time of death, whichever is lower. Here again, the gift tax paid may have been more than the federal estate tax attributable to the transferred property, but the §2012 credit cannot exceed the latter amount.

Because of the gift tax credit, it may sometimes be profitable to make gifts in contemplation of death deliberately. This is because the amount paid as gift tax will be removed from the gross estate (i.e., the gross estate will comprise only the amount of the gift plus the property owned by the donor after payment of the gift tax), but will nevertheless be allowed as a credit against the estate tax. See page 1136 supra.

See Neuhoff, Credit Against Estate Taxes for Gift Taxes Paid, 9 Prac. Law. 45 (1963).

4. *Credit for Tax on Prior Transfers: §2013*

If the decedent (the "transferee") received property from another decedent (the "transferor") and dies within ten years of the transferor, the transferee's estate is allowed a credit under §2013 for the estate tax paid (as defined and adjusted by §2013) by the transferor's estate with respect to the previously taxed property. This credit is the descendant of a provision that came into the estate tax law in

1918, as a result of a recommendation by the House Committee on Ways and Means:

It has come to the attention of the committee that persons closely related have died within such a short space of time that the estate passing within a short period of time has been subjected to the estate tax and thereby diminished unreasonably because of the short period within which the two levies have been made. For example, a husband dies leaving a large amount of property to his wife, an elderly woman, who dies within a few weeks after her husband's death. Under existing law the entire estate is taxed on the transfer from husband to wife and on the transfer from wife to other beneficiaries. [H.R. Rept. No. 767, 65th Cong., 2d Sess., reprinted in 1939-1 C.B. (Part 2) 86, 102.]

To prevent the undue depletion of a family fortune by two estate taxes within a brief period of time, §2013 of the 1954 Code permits the transferee's estate to take a credit for an appropriate portion of the estate tax paid by the transferor's estate. In computing the credit, it is necessary first to determine the amount of federal estate tax attributable to the transferred property in the transferor's estate (the "first limitation" of Regs. §20.2013-2). Then the amount of tax attributable to the transferred property in the transferee's estate is computed (the "second limitation" of Regs. §20.2013-3). The credit actually allowed is the lesser of the two amounts just described, except that if the transferee died more than two years after the transferor the amount to be allowed is reduced on a sliding scale by §2013(c). Only 80 per cent of the normal amount is allowed if the transferee died more than two years but less than four years after the transferor, with further reductions to 60 per cent (transferee's death four to six years after transferor's), 40 per cent (six to eight years), and 20 per cent (eight to ten years). No credit is allowed if the transferee survives the transferor by more than ten years.

The credit (determined by applying the "first" and "second" limitations described above) is also allowed if the transferee's death *preceded* the transferor's by not more than two years. Thus, if A received a gift of property from B in 1963 and died in 1964, his estate would be entitled to a credit under §2013 if B died in 1965 and the property was included in B's gross estate under §2035 (gifts in contemplation of death). The credit would be claimed by A's estate on an amended return since the facts necessary to compute it would probably not have been known when A's return was filed.

To qualify for a credit under §2013, the previously taxed property itself need not be owned by the transferee at the time of his death, nor need it be otherwise includible in his gross estate, since the "second limitation" is applied by computing the difference between the net estate tax payable on the transferee's estate and the amount that would be payable if the value of his estate were reduced by the amount of the transferred property. In effect, it is assumed that the transferee's estate was augmented by the previously taxed property whether he saved it and used his other property for living expenses, or vice versa.

No credit is allowed for any gift tax that may have been paid on property that was transferred to the decedent, no matter how short the interval between the gift and the transferee's death.

See Rudick, The Estate Tax Credit for Tax on Prior Transfers, 13 Tax L. Rev. 3 (1957), characterizing §2013 as "the most complex and confusing provision of the estate tax law." See also Rev. Rul. 59-9, 1959-1 C.B. 232 (decedent as life tenant of a trust established by his father may take a credit for tax paid by father's estate on actuarial value of life estate at father's death, even though transfer did not result in tax on transferee decedent's estate); Rev. Rul. 59-123, 1959-1 C.B. 248 (where decedent's estate was entitled to marital deduction and paid no estate tax, and surviving widow died within short time, the husband's estate may

not waive the marital deduction in order (a) to establish a tax liability on his estate that can be credited by widow's estate and (b) to reduce size of widow's estate); Rev. Rul. 59-73, 1959-1 C.B. 234 (method of computing credit when prior estate received a credit under §2012 or §2013); United States v. Denison, 318 F.2d 819 (5th Cir. 1963) (no credit where prior decedent's estate paid no tax).

Section 2013 is a complete revision, enacted in 1954, of §812(c) of the 1939 Code, which permitted the value of property that had been previously taxed within a five-year period to be deducted from the decedent's estate. The deduction was available whether the prior tax was an estate tax or a gift tax, but it was allowed only if the previously taxed property could be "traced" into the decedent's estate. It was not allowed for transfers between husband and wife, and it was subject to many other complex adjustments. The 1954 changes seem to be an amalgam of the proposals made in Rudick, The Estate Tax Deduction for Property Previously Taxed, 53 Colum. L. Rev. 761 (1953), and Bittker and Frankel, Previously Taxed Property and the Federal Estate Tax, 8 Tax L. Rev. 263 (1953), which copiously annotate the shortcomings of the pre-1954 law.

CHAPTER 16
Valuation of Property

Section 2031(a) provides that the value of the decedent's gross estate "shall be determined by including the value . . . at the time of his death of all property . . ." But §2032 permits the estate, if the executor so elects, to be valued as of one year after the decedent's death.

The Code does not prescribe a method of arriving at the "value" of included property. There is a vague provision for unlisted securities, §2031(b), said to be declaratory of earlier law in Colonial Trust Co. v. Kraemer, 63 F. Supp. 866 (D. Conn. 1945). The Regulations on the subject of valuation (Regs. §20.2031), however, are rather elaborate.

The Code is equally laconic in respect of the gift tax. Section 2512(a) provides: "If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift." The principles of valuation set out in the gift tax Regulations (Regs. §25.2512) are virtually identical with those prescribed by the estate tax Regulations.*

Active stocks and bonds. The Regulations (§20.2031-2) provide that if there is a market for stocks and bonds, on a stock exchange, over-the-counter, or otherwise, their value shall be determined by taking the mean between the highest and lowest selling prices on the valuation date or, if there were no sales on that date, by taking the means for the nearest dates before and after the valuation date and interpolating for the valuation date. If sales are not available for a date within a reasonable period from the valuation date, bid and asked prices may be substituted.

The Regulations go on to provide that if the value of the stocks or bonds as thus determined "does not reflect the fair market value thereof, then some reasonable modification of that basis or other relevant facts and elements of value are considered in determining the fair market value." §20.2031-2(e). The Regulations then acknowledge that the size of the block of securities to be valued may be relevant. In a number of cases taxpayers have been successful in establishing a fair market value below the quoted prices. Havemeyer v. United States, 59 F. Supp. 537 (Ct. Cl. 1945), cert. denied, 326 U.S. 759 (value for gift tax of one stock, $25 instead of quoted price of $28; of another, $22 as against $24.50); Helvering v. Maytag, 125 F.2d 55 (8th Cir. 1942), cert. denied, 316 U.S. 689 ($3.10 as against $4.75); Helvering v. Safe Deposit & Trust Co., 95 F.2d 806 (4th Cir. 1938) ($35 as against $44); see also Montgomery, Federal Taxes — Estates, Trusts and Gifts, 1947-1948, pp. 604-606. Cases of this type have stressed the depressing effect on the market of a sale of a large block of stock. Why is this fact relevant? What of the possibility of realizing the price quoted on the valuation date by engaging a "skillful broker" to dispose of the stock over a period of time? See Bull v. Smith, 119 F.2d 490 (2d Cir. 1941); see also Newberry v. Commissioner, 39 B.T.A. 1123, 1130-1131 (1939). What if such a marketing process could obtain *more* than

* Valuation problems are not, of course, unique to the estate and gift tax field. In applying the income tax, it is often necessary to determine the value of property, e.g., when it is received as compensation, as payment for other property, as a liquidating distribution in partial or complete liquidation of a corporation or redemption of its stock, etc. See Burnet v. Logan, supra page 457

the quoted price? Note that the Regulations speak of "a willing buyer and a willing seller." Granted that a large offering would depress the market, what of the fact that a large demand — "a willing buyer" — would improve it? See Freeman and Vinciguerra, Blockage Valuation in Federal Tax Law, 94 U. of Pa. L. Rev. 365 (1946); Barrett, Valuation of Stocks by the Blockage Rule, 29 Taxes 465 (1951).

Does the portion of the Regulations quoted in the preceding paragraph permit the taxpayer (or the Commissioner) to show that, although the stock could have been sold without difficulty at the quoted price, the estate tax value should be lower or higher because the market price was influenced by groundless hopes or fears of investors?

Inactive stocks and bonds. When there is no recognized market for the securities, the Regulations (§20.2031-2(f)) provide that a variety of "relevant factors" shall be considered, including the goodwill of the business, the economic outlook in the particular industry, the company's position in the industry and its management, and the value of comparable securities. The student will recognize that he is here being beckoned into a morass. Some guideposts, together with a frank warning of the treacherous underfooting, will be found in 2 Paul, Federal Estate and Gift Taxation, c. 18 passim (1942).

The principal problem in the case of closely held businesses (whether incorporated or not) is the value of goodwill. Typically, the estate approaches this issue by arguing that the decedent was the dominant personality in the business, and that his death makes its future success, indeed its very existence, problematical, with the result that there is little or no goodwill to be valued. The government, on the other hand, is inclined to argue that the decedent was in virtual retirement for some time so that his death deprived the business of none of its value. See Gannon's Estate v. Commissioner, 21 T.C. 1073 (1954) (no goodwill survived decedent's death); Danley v. Deal, 48 A.F.T.R. 1574 (N.D. Ala. 1954) (goodwill survived); see also Rothrock v. Commissioner, supra page 1052; Rev. Rul. 60-301, supra page 576 (re goodwill of professional firm).

If the goodwill of the business survives the decedent, it is sometimes valued by the "capitalization of surplus earnings" method described in A.R.M. 34, C.B. No. 2, 31 (1920). The fair market value of the plant, machinery, equipment, and other visible assets of the business is computed and a reasonable rate of return (e.g., 8 to 15 per cent) on these assets is determined; this return is then subtracted from the average annual earnings of the business over a reasonable past period (e.g., 5 to 10 years), and the balance (the "surplus earnings") is then capitalized at a rate that gives effect to the risks of the business (e.g., 20 per cent). Although the A.R.M. 34 method of valuing goodwill may appear at first glance to supply a formula capable of mechanical application, in point of fact it opens the door to a series of arguments over the proper rate of capitalization, etc.; and its basic assumption — that past earnings can be projected into the future — is almost invariably questioned in whole or in part. Experts using this method can arrive at quite divergent ultimate conclusions, and their estimates may be even farther apart if they also employ book value, values of allegedly comparable businesses, and other factors as a guide. See Kelly's Estate v. Commissioner, ¶55,129 P-H Memo T.C., in which the shares of common stock of a closely held publishing company were variously valued at $516 (estate tax return), $1000 (revenue agent), $4000 (90-day letter), $980 (taxpayer's first expert), $822 (taxpayer's second expert), $1320 (taxpayer's third expert), $4000 (government's first expert), $3400 (government's second expert), and $2200 (the court).

For an extended statement by the Internal Revenue Service of the proper way to value the stock of closely held corporations, see Rev. Rul. 59-60, 1959-1 C.B. 237, stating that the factors to be considered include: nature of the business and

its history from "inception"; economic outlook "in general" and in "the specific industry in particular"; book value and financial condition of the business; earning capacity; dividend paying capacity; and any goodwill or other intangible value of the business. See also Polasky, Planning for the Disposition of a Substantial Interest in a Closely Held Business, 44 Iowa L. Rev. 83 (1958); Sprecher, The Valuation of Stock in a Closely-Held Corporation for Federal Gift and Estate Tax Purposes, 31 Ky. L.J. 325 (1942); Rice, Valuation of Close Held Stocks: A Lottery in Federal Taxation, 98 U. of Pa. L. Rev. 367 (1950); Johnson, Shapiro and O'Meara, Valuation of Closely-Held Stock for Federal Tax Purposes: Approach to an Objective Method, 100 id. 166 (1951).

Other property. The Regulations deal, though briefly, with the valuation of real estate, notes, and household and personal effects,* and contain tables for computing the value of annuities, remainders, etc. Tables and formulas for valuing more complex future interests are provided by Actuarial Values for Estate and Gift Tax (I.R.S. Publ. No. 11, 1959). See Nourse v. Riddell, 143 F. Supp. 759 (S.D. Calif. 1956), where the taxpayer succeeded in using mortality tables that were more favorable to his claim than the tables employed by the Treasury.

For the value of life insurance, see Guggenheim v. Rasquin, supra pages 1248 et seq.

On the effect of events occurring after the decedent's death, see Gowetz v. Commissioner, supra page 1276; Goodman v. Granger, supra page 1084. See also Bankers Trust Co. v. United States, 284 F.2d 537 (2d Cir. 1960), cert. denied, 366 U.S. 903, holding that U.S. bonds that could be used by the executor at their par value to pay the federal estate tax were to be valued at par rather than at market value (which was lower).

Property transferred during decedent's life. For the time as of which property transferred during the decedent's life is to be valued, see Frizzell's Estate v. Commissioner, supra page 1137 (gifts in contemplation of death).

Optional valuation date. Section 2032 permits the executor to value the estate as of one year after the decedent's death, instead of using the value on the date of death. This provision, enacted in 1935, is intended to prevent the confiscation of estates when market values decline abruptly after the decedent's death. The House version of the 1954 Code would have permitted the optional valuation date to be used only if there was a decline of one third of the estate's value between the date of death and the optional date. The Senate eliminated this restriction, and §2032 as enacted is a restatement of §811(j) of the 1939 Code.

The provision produces a welter of difficulties, partly because adjustments must be made for property that has been distributed or sold between the date of death and the optional valuation date, as well as for property that "is affected by mere lapse of time." Section 2032(a)(2) and (3); see also Maass v. Higgins, 312 U.S. 443

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* The taxpayer purchased a diamond ring and a pair of diamond ear clips for $200,000 plus federal excise tax of $40,000 and gave them to her daughter a few months later. Should the federal excise tax be taken into account in determining the value of the property in computing the gift tax? What weight should be given to the fact that a private owner could not sell such jewelry at the same price, or as easily, as a dealer? If the jewelry had been purchased in order to make the gift, should the gift tax be computed as though the donor had made a gift of cash to enable the donee to purchase the jewelry? What if the jewelry had been purchased for the donor's own use, but she changed her mind a few weeks later and gave it to her daughter? See Publicker v. Commissioner, 206 F.2d 250 (3d Cir. 1953), cert. denied, 346 U.S. 924 (1954); Duke v. Commissioner, 200 F.2d 82 (2d Cir. 1952), cert. denied, 345 U.S. 906 (1953). After these decisions, the Regulations for the first time referred to this subject. §25.2512-7.

Revenue Rul. 55-71, 1955-1 C.B. 110, states that the federal excise tax is "a relevant factor" in determining fair market value for estate tax purposes because it is "an item which will tend to increase the amount at which . . . an estate would be willing to sell such property."

(1941). What if an extraordinary cash dividend is declared, with the consequence that the shares owned by the estate are of substantially less value on the optional valuation date than on the date of death? What of stock dividends? See Regs. §20.2032-1(d)(4); Schlosser's Estate v. Commissioner, 277 F.2d 268 (3d Cir. 1960) (stock dividends are includible at value on optional valuation date). Where the optional valuation date is elected by the executor, it is also controlling in determining the beneficiary's income tax basis under §1014(a). May the executor use whichever date produces the *higher* value, so as to produce a higher income tax basis for the beneficiaries of the estate? The Internal Revenue Service states that he can, if the value of the gross estate at death was more than $60,000. Rev. Rul. 56-60, 1956-1 C.B. 443.

Income tax basis of inherited property. For the effect of the estate tax valuation on the heir's income tax basis, see page 1074 supra.

BONBRIGHT, THE VALUATION OF PROPERTY*

Vol. 2, pp. 694-696 (1937)

With death duties as with other taxes, one properly looks to the economic or ethical basis of the tax for light on the meaning of "value of the property." But, perhaps more than with any other tax, there is the greatest difference of opinion as to what this basis is. Indeed, as judgment has become more nearly unanimous that the tax is socially desirable, it has become more divergent as to *why* it is desirable. A recent staff report to a Joint Congressional Committee lists nine different economic principles on which various experts have defended the death taxes. These principles include various forms of the old doctrines of "benefit" and of "ability to pay," with additional defenses based on the argument for diffusion of wealth and on the desirability of handicapping the acquisition of wealth except as a reward for the accomplishment of socially useful work. The prevalent view among economists is that no single principle can be accepted to the exclusion of all others, and that the merits of any particular death duty must be judged by reference to a host of probable economic and social consequences.

This last conclusion does not make the task of the theorist an easy one. But so far as concerns the choice of a proper basis of appraisal, the problem is not quite so complicated as might be assumed. For the appraisal is only one of the factors determining the amount of the tax, and its proper basis is not necessarily affected by the precise rationale of the tax. For example, the assumed utility of an inheritance tax as a preventive of enduring family fortunes would hardly suggest a different basis of valuation from that suggested by the principle of "ability to pay."

Without taking a positive position, therefore, on the economic philosophy of the death duties, one may still reach tenable conclusions as to the proper methods of valuation. The basis for such conclusions is to be found in the fact that the burden of the tax falls on the beneficiaries, even if the tax is paid by the executors out of the estate as such. "Value of the property" should therefore be interpreted to mean (or to be an approximate index of) that value which is significant to the beneficiaries — in short, a special form of the concept of "value to the owner." Clearly, the worth of the estate to the decedent is of no consequence here. But equally truly, its market value, in the strict sense of the price at which it might be sold to any outside party, is irrelevant save as a possible measure of the value of the property to those who inherit it.

This last assertion, however, needs further defense, since it would be vigorously

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denied by many writers, and since it seems to run counter to current statute law and common law. The point is made that a death duty, unlike an annual levy under the general property tax, is usually paid by a liquidation of a portion of the estate itself — often a very considerable portion. Moreover, much of the decedent's remaining property must be sold by the executors, partly as a means of paying the expenses of administration, partly as the only feasible method of distribution among the beneficiaries. If the estate has been left in trust, still further liquidation may be called for in order to make the investments qualify for trust funds. Under these circumstances, it is argued, an appraisal under the death duties requires a strict adherence to the standard of market value, defined, not in the traditional but vague sense of a "fair selling price," but as the price, fair or unfair, which the property would actually command if presently offered for sale in the manner available to executors and trustees.

This position has much force — so much so as to justify fewer departures from a market-value standard than are warranted in most other fields of taxation. But it does not constitute an argument for the abandonment of value to the owner as the *ideal* basis of valuation. Instead, it amounts in effect to the sound contention that this latter value is often *measured* by market value, without reference to the special adaptability of the property to the various beneficiaries. For if we grant that the executors or trustees will in fact sell the assets of the estate to outsiders, we must also grant that these assets are worth nothing to the beneficiaries except for their realization value.

Because a valuation based on market price is so *generally* the best available measure of the value of the assets to the beneficiaries themselves, its adoption is justified as a matter of administrative convenience even in many instances in which the assessor has reason to believe that the assets will not in fact be liquidated and that they will come into the possession of beneficiaries to whom they will have a value in excess of their sale price. A frankly crude but workable basis of assessment is preferable to a theoretically refined basis, too complex for ready administration.

But with certain types of inheritances, the discrepancy between the price at which the property could be sold to outsiders, and the value of the property to its beneficiaries, is so wide that it cannot be ignored; and here the market-value standard should be abandoned. The most conspicuous examples in point are those of life estates, remainders, and other forms of divided interests that are literally or practically unsalable. In practice, properties of this nature are valued on actuarial principles discussed in a later section. These appraisals do not reflect market values. Their validity rests solely on their merits as a rough-and-ready measure of the value of these unmarketable properties to their inheritors; and this point is recognized, in effect if not in words, by the opinions of the courts.

Even with marketable forms of property, the assessor is often faced with a significant discrepancy between the price at which the property could be sold and its special value to a beneficiary. An example in point is to be found where the estate contains a large block of stock, which may be readily sold only at a discount from the current market price of 100-share lots, but which may be worth even more than this current market price to the beneficiary, for purposes of controlling an enterprise. This situation gives rise to the "blockage problem," discussed later. Here we are noting simply that, even under the death duties, market value, defined in any one precise sense, is not the *ideal* basis of valuation.

NOTE

Valuing shares of mutual funds. In 1963, the estate and gift tax regulations were amended to provide that the value of shares of mutual funds is the "public offering price"; previously, the field offices had evidently sometimes used the redemption value or the mean between that and the offering price. Regs. §20.2031-8(b); §25.2512-6(b); see also Rev. Proc. 64-18, 1964-17 I.R.B. 31 (for gifts or deaths before promulgation of new regulations, redemption value or mean between it and offering price will be accepted if all interested parties agree to use the same value for income tax purposes).

Does use of the public offering price reflect Bonbright's theory that "value to the heirs" is the appropriate value for death tax purposes?

HIPP v. UNITED STATES

215 F. Supp. 222 (W.D.S.C. 1962)

MARTIN, Chief Judge.

These actions were brought by B. Calhoun Hipp and his wife, Jean Jones Hipp, to recover Federal Gift Taxes paid by them for the calendar year 1956 in the amount of $1,501.40 each. . . .

The cases concern the narrow question of the *value* of the income to a trust for a period of ten years.

On December 20, 1956, B. Calhoun Hipp executed a trust agreement by which he transferred 500 shares of the common capital stock of Liberty Life Insurance Company to The Greenville Branch of the South Carolina National Bank of Charleston, South Carolina, as Trustee. The trust agreement provided that for the period beginning December 20, 1956, and ending December 31, 1966, the net income from the trust be paid to unspecified charities, and upon the expiration of that period the trust corpus be distributed to the children of the taxpayers. The agreement vests in the trustee unlimited discretionary powers to sell the trust assets and to invest the proceeds from such sale in other assets. The trust agreement encompasses two gifts. The gift of the income from the trust for a ten-year period is given to charity and the corpus is given to the taxpayers' children to be paid at the end of the term. For Federal Gift Tax purposes, the gift is considered as made one-half by B. Calhoun Hipp and one-half by his wife, Jean Jones Hipp. A taxpayer is entitled to deduct gifts to charities from the total gifts he makes during any one year.

Each taxpayer filed a timely Federal Gift Tax Return for the year 1956, reporting the gift in trust. On the returns, the taxpayers assigned a market value of $150 per share to the Liberty Life stock or an aggregate value of $75,000 for the 500 shares, then deducted from this amount the purported value of the ten years' income interest given to charity. The taxpayers computed the value of the income interest in accordance with the method prescribed by Treasury Regs. §25.2512-5. The method so prescribed is to multiply the market value of the shares of stock by the factor set forth in Column 3, Table II, Treasury Regs. §25.2512-5. This computation resulted in an assigned value of $21,831.08 (75,000 × .291081 [factor for ten-year term prescribed in Column 3 of the Table]).

Upon audit of the returns, the Commissioner of Internal Revenue determined that the market value of the stock at the date of the gift was $159 per share. Pursuant to this determination, the Commissioner assessed deficiencies[1] in gift tax against each of the taxpayers and on September 8, 1958, the taxpayers each paid

[1] In computing the deficiencies the Commissioners used the method of valuing the gift to charity as used by the taxpayers which was the method prescribed by the regulations.

the additional gift tax in the amount of $237.10, plus interest. Subsequently, on April 15, 1960, the day on which the statute of limitations against assessment of additional gift tax against the plaintiffs for the year of the gift would otherwise expire, the Commissioner sent to each of the taxpayers a statutory notice of deficiency proposing a further deficiency in Federal Gift taxes for the year 1956 in the amount of $1,251.58. On August 26, 1960, the taxpayers paid this second deficiency, plus interest, in the amount of $249.82.

The basis for this second deficiency determination was explained in the notices to the taxpayers which read:

> Factor .291081 for the value of a term certain for ten years (.291081 × value of corpus) does not apply because this factor is based on a return of 3½% whereas the expected return on this gift of $1.00 per share is considerably less than a return of 3½%.

The method substituted by the Commissioner was to treat the gift to charity as an annuity of a fixed and definite dollar amount equal to the annual cash dividend being paid on Liberty Life Insurance Company common stock at the date of the gift. This method assumed income to the trust of $1.00 per share for ten years discounted by 3½% compounded annually. The computation of the value is as follows: 500 × 1.00 = $500 × 8.3166[2] = $4,158.30.

Claims for refund of the second deficiency assessments were filed with the District Director of Internal Revenue for the District of South Carolina on September 22, 1960. On December 27, 1960, the District Director formally rejected each of the claims for refund and these actions followed.

At the time the trust agreement was executed B. Calhoun Hipp was a director and the Administrative Vice-President of Liberty Life and held 15.1% of the outstanding shares of common stock of the company. The other major stockholders of the company are two brothers of B. Calhoun Hipp and a sister. Collectively, the Hipps control more than fifty per cent of the voting stock of the company.

The value of most gifts are determined by the market value. Market value is defined by Treasury Regs. §25.2512-1 as:

> The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell, and both having reasonable knowledge of the relevant facts. . . .

This approach cannot be used, however, when the property to be valued is not purchased and sold on the market. In such cases the value is determined by methods prescribed by [Regs. §25.2512-5].

The problem before the Court is to determine whether the value of the income interest is determined by the regulation or whether the regulation does not apply and some other formula should be used. The Government argues that the regulation is not applicable on the ground that the table is designed for use where there is an absence of facts and that there are facts in the present case which establish the value of the income interest. If the actual value of the income interest can be determined with any degree of certainty, the method of valuation prescribed by the regulation is not applicable.

The Government argues that during the period from 1952 through 1956, 500 shares of Liberty Life stock produced $500 per year in earnings and that as of the date of the gift this earning record was expected to continue during the next ten years. If we assume that 500 shares of stock were placed in a trust in 1952, the yield produced is as follows:

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[2] The factor was obtained from Column 2 of Table II of Regs. §25.2512-5(f).

1952 —	$1,000.00
1953 —	" "
1954 —	" "
1955 —	" "
1956 —	" "

This increase in dividends was caused by a 100% stock dividend in March 1952 so that the imaginary trust would have held 1,000 shares of stock after the dividend date and the income to the trust would have been $5,000.00. Percentage-wise, upon an initial investment of $49,500 [the market value of the stock on January 1, 1952], the yield would have been 2%. The Government contends that the percentage of yield would have been .62% but this computation is based only on the cash dividends and does not take into account the increase in income by reason of the increase in the number of shares held by the trust during the period.

The Government also argues that the use of the regulation would be unreasonable in this particular case on the ground that the taxpayers must show the probable yield per share as of 1956 was 3½%. Further, it is argued that the highest yield in the preceding ten-year period was $2.45, 56% less than the $5.56 average required. This argument encompasses a comparison of uncomparables. It compares an average dividend of $2.45, during a period when the fair market value of the stock at the beginning of the period was $42.00 with an average assumed dividend of $5.56 during a period when the fair market value of the stock was $159. When the two amounts are reduced to comparables, i.e. percentages, a different picture is presented. During the period from 1944 to 1953, although the average yield was only $2.45 per year, the percentage yield based on the fair market value at the beginning of the period was 5.83% [$2.45 dividend divided by $42 market value] as compared with 3½% which is taken from the table. Then too, the Government's computation does not take into account the stock dividends paid in 1944, 1947 and in 1952.

It is well settled that the determination of the Commissioner is presumptively correct and such determination is binding upon the Court if it is supported by substantial evidence but where the method pursued by the Commissioner is erroneous, the presumption of the correctness of the determination no longer avails. Clinton Cotton Mills v. Commissioner (4th Cir., 1935), 78 F.2d 292.

In the present case it is obvious that the Commissioner's determination in computing the second deficiency against the taxpayers did not take into account the actual earnings of Liberty Life stock during the four-year period upon which it based the projected earnings of the trust during the period the trust was to produce income for the benefit of charities. As explained above, the Government erroneously assumed that one share of Liberty Life stock produced $1.00 in income per year during the four-year period which served as the base period for projecting the expected income, and did not take into account the fact that in the first year of the base period, the company declared a 100% stock dividend so that during the period an imaginary trust would have earned $2.00 on each share which it held at the outset of the period. This erroneous approach by the Commissioner destroys whatever presumption his determination would ordinarily carry.

The valuation of future interest is at best a highly speculative undertaking not unlike the determination of life expectancy which courts and juries are called upon to make in almost all personal injury actions. Recognizing that the value of future interest cannot be determined with any degree of certainty, those called upon to make valuations have resorted to established computations which seldom

accurately predict the value in a particular situation but prove to be accurate when used in a great number of instances. In McMurtry v. Commissioner (1st Cir., 1953), 203 F.2d 659, where the Government successfully opposed the taxpayer's effort to depart from the regulations, Chief Judge Magruder stated:

> . . . The whole problem of valuing individual life interests by resort to mortality tables is at best a matter of educated guesswork. The courts cannot demand perfection in an area so fraught with speculation and uncertainty . . . [page 666.]

In Gelb v. Commissioner (2d Cir., 1962), 298 F.2d 544, the Court said:

> Yet the use of actuarial tables for dealing with estate tax problems has been so widespread and of such long standing that we cannot assume Congress would have balked at it here; the United States is in business with enough different taxpayers so that the law of averages has ample opportunity to work. [page 551.]

In Bowden v. Commissioner (5th Cir., 1956), 234 F.2d 937, the Court quoted with approval the following language from McMurtry v. Commissioner:

> We think, therefore, that tables which have enjoyed such widespread and long-standing use should not be rejected as wholly unreasonable, even though they may perhaps be susceptible of minor improvements in particular respects. Such discrepancies as may exist will no doubt average out in the long run; and while this may sometimes prove to be unfortunate for individual taxpayers, the discrepancies may have to be suffered in the interest of a simplified overall administration of the tax laws. [page 941.]

The Government argues, and the taxpayers concede, that where the facts show that a valuation can be made in a particular case with exactitude, the tables should not be used. In the present case, however, the valuation of the gift cannot be determined with any degree of certainty. Certainly it would be incorrect to say that each share of stock will produce $1.00 in income during the period of the trust. It may well be that the income will prove to be less than the return anticipated by the regulation but the Court cannot establish the value of the income interest.

A brief résumé of the history of Liberty Life will show how difficult it is to determine income from its common stock during the period of the trust.

On January 1, 1941, Liberty Life Insurance Company had issued an outstanding 40,000 shares of its common capital stock. By reason of stock dividends paid in November 1942, October 1944, October 1947 and March 1952, the number of shares outstanding on the date of the gift had increased to 200,000 shares. Each time the company paid a stock dividend it maintained essentially the same cash dividend rate per share, with the result that issuance of stock dividends caused increases in cash dividends paid to the shareholders.

Since 1939, when the capital stock of Liberty Life was first offered to the public, the company had consistently paid regular cash dividends. The amount of the cash dividends had substantially increased over the years prior to 1956.

On December 20, 1956, Liberty Life Insurance Company had behind it a record of continuing growth and prosperity. During the period 1941-1956 its net investment profit, net earnings, book value, insurance in force, and total assets, had all increased by more than 1000%. On the date of the gift, shares of outstanding stock were held by 892 shareholders; there was something over $817,649,814.00 of insurance in force; and the total assets of the company were in excess of $92,-284,068.45. On the date of the gift, there was reason to believe that the company would continue to enjoy rapid growth and expansion.

In every ten-year period in the history of Liberty Life, prior to the date of the gift, the amount of cash dividends paid to stockholders had significantly increased. The average annual cash dividends paid to stockholders of Liberty Life

during the seven ten-year periods, commencing with the period 1941-1950, and ending with the period 1947-1956, expressed as a percentage of the fair market value of the stock at the beginning of each period, ranged from a high of 7.18% to a low of 2.47% and averaged 4.51% for all such periods.

The management and board of directors of the company, and the investing public, anticipated at December 20, 1956, that cash dividend payments by the company would be increased substantially during the ten-year period subsequent to December 20, 1956. The management and board of directors anticipated that, in addition, there would be in early 1957, an increase in cash dividends. Taxpayers' witnesses testified, that it was not unreasonable to forecast an average annual return of 3½% on Liberty Life stock during the period the trust was to exist. Mr. Charles D. Behrens, Executive Vice-President and a Director of Moody's Investors Service who gave testimony during the trial, testified that he had made a careful study of Liberty Life and based on his knowledge and experience a return of 3½% on Liberty Life stock during the period of the trust would be within the range which could be expected.

The Government relies on Hamm v. Commissioner, ¶61,347 P-H Memo T.C. (1961). In that case Mr. Hamm executed on July 1953, two written trust agreements by which he designated himself to be the sole trustee and providing that the income interest accruing to each trust should be paid to the Hamm Foundation, a charitable organization, until March 1, 1964. In December 1953, petitioner executed a first addendum to each trust, by which he made gifts of the stock of United Properties Inc., a family investment and holding corporation to each of the trusts. By such addendums, petitioner transferred 130 shares to Trust I and 133⅓ shares to Trust No. II.

One of the questions presented in the case was whether the petitioner was entitled to a charitable deduction for the gifts of income to be derived from the shares of United to the Trusts. The Court held that at the time of the gifts it was improbable that the charity, (Hamm Foundation) would ever derive any net income in respect to the gifts involved. The Court said:

> It would not be proper in our opinion, in the circumstances of the instant case, to value the 10-year income interest of the Hamm Foundation through use of the table contained in the respondent's Gift Tax Regulations, which is provided for use in valuing certain estates for life or for terms of years. In the instant case, as above shown, there was no probability that charity would ever take anything; and hence it would be wholly unrealistic to apply the table here. Said table assumes an annual yield of 3½ percent; but in the instant case, any yield whatsoever on United's common stock was wholly improbable, and likely to be nil. . . . This Court has held that where the probable yield is either significantly greater, or significantly less than the yield assumed in the table, then regard should be had to the actualities of the particular case, rather than to the assumption built into the table.

The facts in the *Hamm* case places it squarely in the exception set forth by Regs. §25.2522(b) which provides:

> . . . The deduction is not allowed in the case of a transfer in trust conveying to charity a present interest in income if by reason of all the conditions and circumstances surrounding the transfer it appears that the charity may not receive the beneficial enjoyment of the interest. For example, assume that assets placed in a trust by the donor consists of stock in a corporation, the fiscal policies of which are controlled by the donor and his family, that the trustees and remaindermen are likewise members of the donor's family, and that the governing instrument contains no adequate guarantee of the requisite income to the charitable organization. Under such circumstances, no deduction will be allowed. Similarly, if the trustees are not the donor's family but have no power to sell or otherwise dispose of closely held stock, or otherwise insure the requisite enjoyment of income to the charitable organization, no deduction will be allowed.

There is no contention by the Government that the exception applies to the present case.

The facts in the *Hamm* case are far different from those before the Court in the present actions. In the *Hamm* case, the circumstances affecting the Corporation, United, made it unlikely that there would be any payment of dividends at all to the trusts. The trustee to whom the dividends were to be paid was an officer of the corporation. Here, there is every reason to believe that the dividends from Liberty Life stock will be available for gifts to charity.

After a careful study of the evidence presented in the case relating to the income possibilities of Liberty Life stock and the power conferred upon the trustee to sell the corpus assets and reinvest the proceeds in other assets, the Court is convinced that any valuation of the income interest would be little better than a guess. In such a case it is clear that the method prescribed by the regulation should be used.

NOTE

1. *Dividend policy of closely held corporation.* If the directors of the corporation (who presumably can be elected by the Hipp family by virtue of its ownership of more than 50 per cent of the corporation's voting stock) caused the corporation to reinvest its earnings during the ensuing 10-year period rather than to pay dividends, and their action was not so flagrant as to constitute an actionable breach of their fiduciary obligation to the shareholders, could the charitable deduction be retroactively disallowed? In the case itself, a withholding of dividends would have had important business ramifications, since there were 892 shareholders, and the trust owned only a small fraction of the outstanding shares. What if all the stock had been owned by the taxpayers, and they had transferred a substantial block in trust? Consider also the alternative possibility: a transfer of stock of a family corporation in trust (inter vivos or at death), income to go to the transferor's children for life, remainder to chairities. If the children or other members of the donor's family can control the corporation's dividend policy, and its net worth is represented almost entirely by earned surplus, available for the payment of dividends, can the charitable deduction be computed as in the *Hipp* case?

2. *Mortality tables.* Although the courts have adhered to the mortality tables in determining the life expectancy of a life tenant as of the valuation date even though he died before his time, the tables are not necessarily controlling if there is evidence that his health was substantially below average on the valuation date. Compare Ithaca Trust Co. v. United States, 279 U.S. 151 (1929) (widow's life expectancy on date of death is controlling in computing value of charity's remainder interest, despite her death within six months after decedent's death); with Hoelzel's Estate v. Commissioner, 28 T.C. 384 (1957) (widow incurably ill when decedent died; held, her actual life expectancy rather than mortality table is controlling in computing marital deduction), and cases there cited.

On the possibility that actuarial tables (e.g., on the likelihood of remarriage or having children) may be unreliable in a particular case because the very financial interest that is to be valued provides the person in question with an incentive to depart from the average pattern, see *Sternberger's Estate,* supra page 1284.

UNITED STATES v. LAND
303 F.2d 170 (5th Cir. 1962)

Before Rives and Wisdom, Circuit Judges, and Carswell, District Judge.

Wisdom, Circuit Judge.

These cases pose a problem in the valuation, for federal estate tax purposes, of a partnership interest subject to a restrictive agreement limiting the sales price of the interest to two-thirds of its value in the event of its sale during the partner's lifetime. The district court agreed with the taxpayers that the restriction limited the valuation to two-thirds of the property's calculated net value. We

reverse. A restriction on the value of a partnership interest that expires at the decedent's death cannot affect the valuation of the interest for estate tax purposes.

The decedents, John Robert Land and his father, Robert Land, were members of a family partnership, Land Brothers & Company, formed in 1939 to engage in the general merchandise business in Melvin, Alabama. The partnership agreement provided that if any member wished to withdraw from the partnership during his lifetime the other partners would have the option of purchasing his interest at two thirds its calculated value. At the death of a partner, the surviving partners became entitled to purchase his interest at its full value; if they did not do so, the partnership would be dissolved and its assets liquidated and distributed. John Robert Land died January 5, 1955. His father died a few months later. In reporting the value of each decedent's partnership interest the executors reduced the fair market value by one-third on the theory that value is determined before death and that the restriction controlled the valuation for federal estate taxes. There is no dispute as to the value of the interests apart from the controversy over the effect of the restriction in the partnership agreement.

The taxpayers rely primarily on the Supreme Court's pronouncement in Edwards v. Slocum, 1924, 264 U.S. 61, that the object of an estate tax is "not the interest to which some person succeeds on a death, but the interest which ceased by reason of the death." This reliance is misplaced. This is another instance of the truth of Justice Holmes's observation that there is "danger [in] reasoning from generalizations unless you have the particulars which they embrace in mind." [1] As other courts have pointed out in[2] referring to Edwards v. Slocum, the Supreme Court described the estate tax as one on "the interest which ceases by reason of the death" simply to distinguish it from a succession tax, which is calculated and graduated on the individual portion of the estate each heir or legatee receives rather than on the aggregate property passing from the decedent. Edwards v. Slocum did not involve the valuation of property for estate taxes.[3]

The statute applicable here is the general provision, Section 2033 of the Internal Revenue Code of 1954. This provides that "the gross estate shall include the value of all property . . . to the extent of the interest therein of the decedent at the time of his death." The Regulations reiterate the truism that the tax is "an excise tax on the transfer of property at death and is not a tax on the property transferred." Treas. Reg. 20.2033-1(a). It is of course imperative that the tax be imposed on the *transfer* of the property in order to avoid the constitutional prohibition against unapportioned direct taxes. From this, it seems to us, it follows that the valuation of the estate should be made at the time of the transfer. The time of transfer is the time of death. Treas. Reg. 20.2031-1(b). In Knowlton v. Moore, 1900, 178 U.S. 41, 56, the Supreme Court said, "tax laws of this nature in all countries rest in their essence upon the principle that death is the generating source from which the particular taxing power takes its being and that it is the power to transmit, or the transmission from the dead to the living, on which such taxes are more immediately rested." See Shedd's Estate v. Commissioner, 9 Cir., 1956, 237 F.2d 345, 350, cert. denied, 352 U.S. 1024.

1 Holmes, "Law in Science and Science in Law," 12 Harv. L. Rev. 443, 461 (1899).

2 See Goodman v. Granger, 3 Cir., 1957, 243 F.2d 264, 268, cert. denied, 355 U.S. 835; Christiernin v. Manning, D.C.N.J., 1956, 138 F. Supp. 923, 926.

3 The question in Edwards v. Slocum was whether the estate could claim as a charitable deduction the full amount of the before-tax residue even though the residue (and therefore the amount received by the charity devisees) would necessarily be reduced by the payment of the estate taxes. The Court allowed the full deduction, but was later overruled by legislation. See Section 807 of the Internal Revenue Act of 1932. This deduction is a matter of legislative grace which could be varied as Congress saw fit, and should not be expected to dovetail with tests for valuation of property in the estate.

Brief as is the instant of death, the court must pinpoint its valuation at this instant — the moment of truth, when the ownership of the decedent ends and the ownership of the successors begins. It is a fallacy, therefore, to argue value before — or — after death on the notion that valuation must be determined by the value either of the interest that ceases or of the interest that begins. Instead, the valuation is determined by *the interest that passes,* and the value of the interest before or after death is pertinent only as it serves to indicate the value *at* death. In the usual case death brings no change in the value of property. It is only in the few cases where death alters value, as well as ownership, that it is necessary to determine whether the value at the time of death reflects the change caused by death, for example, loss of services of a valuable partner to a small business.

An examination of several instances where the value of a decedent's property differs after death from its value during his life indicates that whether the subsequent value is increased or reduced, the valuation at death uniformly gives full effect to the change that accompanies the death. In Goodman v. Granger, 3 Cir., 1957, 243 F.2d 264, cert. denied, 355 U.S. 835, the court was called on to evaluate three employment contracts carrying contingent benefits of $2000 annually for fifteen years after termination of the employee's employment, provided that the employee did not engage in any competing business for a certain period of time and provided that his post-employment earnings from other work did not exceed a specified amount. The trial court held that the value of the contracts must be limited to the interest of the decedent during his life and that his interest could not be valued because of the contingencies. On appeal the Third Circuit reversed. It ruled that since the possibility of forfeiture was extinguished by the decedent's death the contract rights should be given their full value for estate tax purposes. In May v. McGowan, 2 Cir., 1952, 194 F.2d 396 a father and son had organized a corporation which assumed a large debt owed by the father. Each agreed that he would not sell his stock without first offering it to the other at a specified price, and if the son should buy his father's stock the price was to be reduced by the amount of any portion of the debt still outstanding. At the death of either the other would become entitled as of right to purchase the stock at the same specified price. The father died while the debt still exceeded the price the son was to pay for his father's stock, and the question arose as to the valuation of the father's stock for estate taxes. Although the stock presumably must have had some value during the father's life, because of his right to hold it so long as he lived and to receive any dividends paid, the Court found that the stock was valueless for estate tax purposes since the son could acquire it under the agreement for nothing once his father died. Similarly, when the value of an interest in a corporation or partnership depends in part on the decedent's ability, activity, or goodwill, the value for estate taxes will be reduced to reflect the loss of the decedent. Newell v. Commissioner, 7 Cir., 1933, 66 F.2d 102; see Estate of Maddock, 1951, 16 T.C. 324. The same rule applies in the case of life insurance contracts. During the life of the insured the value of a policy is its cash surrender value. After death the beneficiary holds a ripened claim for the face value. See Commissioner v. Chase Manhattan Bank, 5 Cir., 1958, 259 F.2d 231, cert. denied, 359 U.S. 913. Section 2042 expressly provides that the latter valuation shall be used in determining estates taxes.[4]

[4] The valuation of annuities further illustrates the practice of referring to its future value. In Mearkle's Estate v. Commissioner, 3 Cir., 1942, 129 F.2d 386 the decedent owned an annuity payable to himself during his life, then to his wife for her life. The court valued the contract at the purchase price of an equivalent annuity contract for the life of the wife based on her life expectancy at the decedent's death, without reference to his life expectancy or their joint life expectancy. See also Christiernin v. Manning, D.C.N.J., 1956, 138 F. Supp. 923.

Underlying the determination in these instances that the valuation of property passing at death reflects the changes wrought by death is a basic economic fact: value looks ahead. To find the fair market value of a property interest at the decedent's death we put ourselves in the position of a potential purchaser of the interest at that time. Such a person would not be influenced in his calculations by past risks that had failed to materialize or by restrictions that had ended. Death tolls the bell for risks, contingencies, or restrictions which exist only during the life of the decedent. A potential-buyer focuses on the value the property has in the present or will have in the future. He attributes full value to any right that vests or matures at death, and he reduces his valuation to account for any risk or deprivation that death brings into effect, such as the effect of the death on the brains of a small, close corporation. These are factors that would affect his enjoyment of the property should he purchase it, and on which he bases his valuation. The sense of the situation suggests that we follow suit.

It might be argued that the Regulations abandon this approach and look to the past rather than the future in certain cases. Section 20.2031-2(h) provides that when stock is held subject to an option that is to take effect at death but leaves the decedent free to dispose of the property during his life, the option or contract price will not control the evaluation for estate tax purposes. See Estate of Giannini, 1942, 2 T.C. 1160, 1176-80, aff'd without discussion of this point, 9 Cir., 1945, 148 F.2d 285, cert. denied, 326 U.S. 730. This rule is based, however, on an entirely different foundation: when a decedent retains complete freedom to prevent the property being subjected to a restriction or contingency his inaction constitutes a passive transfer of an interest in the property to the person who stands to benefit by the limitation on the value of the property passing to the decedent's heir or legatee.[5] The rule applies the same principle that underlies Section 2038 and 2041, which include within a decedent's estate property over which he held a power of disposition or appointment.[6] Under this analysis such a case does not present a problem of changing value; the interest simply is split and passes to different persons, but its total value is unaltered, and that is the value included in the estate.

The cases relied on by the appellees are not in point. They involve restrictions which not only were in effect during the decedent's life but were effective and enforcible on his death; Wilson v. Bowers, 2 Cir., 1932, 57 F.2d 682; Lomb v.

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5 In Goodman v. Granger, 3 Cir., 1957, 243 F.2d 264, 269, cert. denied, 355 U.S. 835, the Court stated: "True, the right to these payments was forfeitable upon the occurrence of any of the specified contingencies. However, forfeiture as a result of the contingencies never occurred during Blum's lifetime, and any possibility of their occurrence was extinguished by his death. Gimbels has been making and the estate has been collecting the payments provided by the contracts. Valuation of the right to these payments must be determined as of the time of Blum's death when the limiting factor of the contingencies would no longer be considered. Death ripened the interest in the deferred payments into an absolute one, and death permitted the imposition of the tax measured by the value of that absolute interest in property."

6 In Chase National Bank of City of New York v. United States, 1929, 278 U.S. 327, 335, the Supreme Court held the estate tax could properly be imposed on the transfer of the decedent's life insurance at his death, although the interest of the beneficiaries had vested before his death and the proceeds were paid to them by the insurance company rather than by the decedent. The Court stated: "A power in the decedent to surrender and cancel the policies, to pledge them as security for loans and the power to dispose of them and their proceeds for his own benefit during his life which subjects them to the control of a bankruptcy court for the benefit of his creditors . . . and which may, under local law applicable to the parties here, subject them in part to the payment of his debts . . . is by no means the least substantial of the legal incidents of ownership, and its termination at his death so as to free the beneficiaries of the policy from the possibility of its exercise would seem to be no less a transfer within the reach of the taxing power than a transfer effected in other ways through death." See also Saltonstall v. Saltonstall, 1929, 276 U.S. 260.

Sugden, 2 Cir., 1936, 82 F.2d 166. See Mertens' Law of Federal Gift and Estate Taxation §9.08. Thus, in Wilson v. Bowers the Court emphasized the fact that there was a specifically enforcible contract giving the shareholders the right to purchase stock at a specified price upon the owner's intended disposal of the stock *or upon his death*. In Lomb v. Sugden the same court held a restriction conclusive of value where there was an enforcible agreement giving the decedent the power of disposal within a group. Other cases have distinguished between an enforcible option immediately exercisable at the will of the buyer, as in Wilson v. Bowers, and a mere right of first refusal. Worchester County Trust Co. v. Commissioner, 1 Cir., 1943, 134 F.2d 578; Michigan Trust Co. v. Commissioner, 27 B.T.A. 556 (1933). Both in Wilson v. Bowers and in Lomb v. Sugden it was decisive that the maximum price realizable by the estate was the option price, because the optionees having the right to buy could and probably would buy at the reduced value — before or after death of the decedent. Not so here. Here the option to sell at the reduced price had expired, and there is no reason to assume that the executors would sell below the fair market value.

Even if the partnership interest should, as the appellees contend, be valued at the moment before the decedent's death, it would be improper to limit the valuation to two-thirds its value. Although the Supreme Court in Helvering v. Salvage, 1936, 297 U.S. 106, declared that an option held by a stranger limits the value of the property to its owner to the option price, that decision should not be extended to cases where the restriction is only an obligation to offer the property to the third person at a pre-arranged price *if* the owner should decide to sell. The reasoning behind the decision in Helvering v. Salvage is that if the value of the property rises above the option price the optionee will certainly exercise his option. But in the instant case the decedent had no such fear that they would lose their partnership interest as soon as it reached a certain value; the agreement reserved to each partner the right to hold his interest indefinitely, and the restriction on its sale price would become effective only if the partner chose to sell during his lifetime. Although the restriction would reduce the value of the interest somewhat, immediately saleability is certainly not the only attribute of value. The decedent's right to hold the interest and receive income from it, with the assurance that eventually the interest would be redeemable at full value, would raise its current value well above the restricted price applicable during his life. While it would not be possible to determine the proper valuation exactly, an approximate estimate would be more acceptable than the arbitrary application of the two-thirds price.

When John Robert Land and his father died, the possibility that either would withdraw from the partnership and surrender his interest at the two-thirds valuation was foreclosed. There was then no contract or option outstanding except in the partners to purchase at full value. Death sealed the fact that their interests would be purchased or redeemed at full value. The fair market value, therefore, of the partnership interest at the time of the death of the partner was its full value. That valuation is controlling for estate tax purposes.

The judgment is reversed.

NOTE

1. *I.R.S. position on restrictive agreements.* The current view of the Internal Revenue Service on the effect, for estate and gift tax purposes, of a restrictive agreement among shareholders is expressed in Rev. Rul. 59-60, 1959-1 C.B. 237 as follows:

> Frequently, in the valuation of closely held stock for estate and gift tax purposes, it will be found that the stock is subject to an agreement restricting its sale or transfer.

> Where shares of stock were acquired by a decedent subject to an option reserved by the issuing corporation to repurchase at a certain price, the option price is usually accepted as the fair market value for estate tax purposes. See Rev. Rul. 54-76, C.B. 1954-1, 194 [option price controlling where embodied in corporate charter]. However, in such case the option price is not determinative of fair market value for gift tax purposes. Where the option, or buy and sell agreement, is the result of voluntary action by the stockholders and is binding during the life as well as at the death of the stockholders, such agreement may or may not, depending upon the circumstances of each case, fix the value for estate tax purposes. However, such agreement is a factor to be considered, with other relevant factors, in determining fair market value. Where the stockholder is free to dispose of his shares during life and the option is to become effective only upon his death, the fair market value is not limited to the option price. It is always necessary to consider the relationship of the parties, the relative number of shares held by the decedent, and other material facts, to determine whether the agreement represents a bonafide business arrangment or is a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth. In this connection see Rev. Rul. 157, 1953-2 C.B. 255 [option effective only on death not controlling], and Rev. Rul. 189, 1953-2 C.B. 294 [where corporation had right of first refusal at a fixed price or at a price to be determined by formula, price is not controlling because shareholder was not required to sell, but restriction is a factor to be considered in determining fair market value].

See also Regs. §20.2031-2(h):

> Another person may hold an option or a contract to purchase securities owned by a decedent at the time of his death. The effect, if any, that is given to the option or contract price in determining the value of the securities for estate tax purposes depends upon the circumstances of the particular case. Little weight will be accorded a price contained in an option or contract under which the decedent is free to dispose of the underlying securities at any price he chooses during his lifetime. Such is the effect, for example, of an agreement on the part of a shareholder to purchase whatever shares of stock the decedent may own at the time of his death. Even if the decedent is not free to dispose of the underlying securities at other than the option or contract price, such price will be disregarded in determining the value of the securities unless it is determined under the circumstances of the particular case that the agreement represents a bona fide business arrangement and not a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth.

With these statements, see Regs. §20.2031-3, stating:

> Special attention should be given to determine an adequate value of the good will of the business in all cases in which the decedent has not agreed, for adequate and full consideration in money or money's worth, that his interest passes at his death to, for example, his surviving partner or partners.

Does this imply that if two partners or shareholders agree that the first to die will forfeit his business interest on death in favor of the other, nothing will be included in the gross estate?

Note the explanation given in the *Land* case for Giannini's Estate v. Commissioner, where the decedent was free to dispose of the shares during his lifetime at their full fair market value. If the difference between the fair market value at death and the option price was the subject of a "transfer" by the decedent to the optionee, did the transfer occur when the agreement was executed, or at death? Should the putative transfer be regarded as made for full and adequate consideration in money or money's worth? The court in *Giannini's Estate* expressed the view that the option "was intended to take effect in possession and enjoyment at or after the optionor's death and therefore the fair market value of the property is includible in [the] gross estate under the rationale of Helvering

v. Hallock [supra p. 1181]." To the extent that this theory rests on the postponed-possession-or-enjoyment clause (supra p. 1177), is it valid under today's statute?

For cases citing and following *Giannini's Estate,* see Trammell's Estate v. Commissioner, 18 T.C. 662 (1952); Mathews' Estate v. Commissioner, 3 T.C. 525 (1944).

If the executor elects to employ the optional valuation date of §2032, and the shares have been purchased under the option before then, does the option price become controlling?

How should a restrictive agreement affect the value of stock for gift tax purposes? Assume that the agreement provides that a shareholder may transfer his stock by gift or otherwise only after offering it to the corporation at book value, and that this restriction is equally binding on the transferee. If the corporation allows the shareholder to make a gift of the stock to his son (by declining to exercise its option), does it follow that the value of the gift is no more than book value? See Spitzer v. Commissioner, 153 F.2d 967 (8th Cir. 1946).

2. *Intra-family agreements.* Note the reservation in both Regs. 20.2031-2(h) and Rev. Rul. 59-60, supra, with respect to an agreement that is "a device to pass the decedent's shares to the natural objects of his bounty for less than an adequate and full consideration in money or money's worth." Despite this warning, restrictive agreements that are otherwise airtight have ordinarily withstood attacks based on the "testamentary substitute" theory, at least if the children or other optionees were active in the business before the decedent's death. See Littick's Estate v. Commissioner, 31 T.C. 181 (1958); Davis v. United States, 5 A.F.T.R.2d 1902 (D. Utah, 1960); Commissioner v. Bensel, 100 F.2d 639 (3d Cir. 1938); May v. McGowan, 194 F.2d 396 (2d Cir. 1952).

Even if the agreement is intended as "a device" to transfer the decedent's shares to his beneficiaries for less than their fair market value, should it be given effect on the ground that the difference between the option price and the unrestricted value of the stock was transferred by an inter vivos gift from the stockholder to the option holder? Could there be a gift tax on the execution of an agreement by which a father gave his son the right to purchase his shares for a stated price on his death if the son survives him? Would a failure to exercise a favorable option constitute a taxable gift?

In Matter of Galewitz, 3 A.D.2d 280 (N.Y. 1957), the court held that part of the federal estate tax was to be apportioned against the decedent's son, who purchased his stock under a shareholders' agreement for $600,000, because it was valued at $1.3 million in the federal tax proceeding. The court held that although purchasers are not ordinarily "persons interested in the estate" within the meaning of §124 of the New York Decedent Estate Law (requiring apportionment of the estate tax, infra page 1360), the optionee under such an agreement is subject to the statute because "while the option is valid in contract law, its status tax-wise is not that of a bona fide sale contract, but of a transfer, part-sale, and part-gift."

3. *References.* Polasky, Planning for the Disposition of a Substantial Interest in a Closely Held Business (Part III), 46 Iowa L. Rev. 516 (1961); Molloy, Restraints on Alienation and the Internal Revenue Code, 7 Tax L. Rev. 439 (1952); Pavenstedt, The Second Circuit Reaffirms the Efficacy of Restrictive Stock Agreements to Control Estate Tax Valuation, 51 Mich. L. Rev. 1 (1952).

CHAPTER 17

Payment, Collection, and Apportionment

Section A. The Estate Tax

1. *Payment and Collection*

COLLIE, TAX RESPONSIBILITIES OF EXECUTOR

Proceedings of Probate and Trust Law Divisions, A.B.A. Section of Real Property, Probate and Trust Law (Sept. 17-19, 1951) 24-28

I. Estate Notices

The first document which an executor should prepare and file is believed to be unnoticed generally in many parts of the country, even by experienced executors. This is the notice of the assumption of the office of the executor and when properly served upon the Commissioner of Internal Revenue places the executor in the fiduciary relationship insofar as the Commissioner is concerned and continues him in that position until he is properly discharged. . . .

It is generally held that failure to give the notice of appointment in the prescribed form does not relieve the executor of his responsibility to the Federal Government, irrespective of a discharge by the Probate Court. Ordinarily the possibility of a penalty for failure to file such notice would seem to be remote. However it is important to remember that before an assessment is valid, the Commissioner must issue a properly addressed deficiency notice to the taxpayer. The deficiency notice to a decedent is properly addressed if sent to his last known address [§6212(b)] unless the executor has given a notice of fiduciary relationship. It is quite possible to envision circumstances of surcharge if a deficiency notice is not duly received by the executor due to his failure to give the proper notice. . . .

Thereafter the executor is required [§6036; Regs. §20.6036-1] to file a preliminary notice within two months after the deceased's death or two months after the date the executor qualified as such, whichever of such dates is later. This notice must be filed if the *gross* estate exceeds $60,000 at the date of death. This value is determined under the Federal estate tax statute and has no relevance to the probate estate. Therefore the executor has the duty of examining the affairs of the deceased to ascertain whether or not there are any assets such as life insurance or gifts in contemplation of death, which might raise the gross taxable estate to more than $60,000. This notice must be filed regardless of the deductions of the estate or any contention with respect to the exclusion of such property from the estate. The regulations [§20.6036-1] provide that such notice should be prepared and filed if an examination indicates any doubt of the $60,000 requirement being met and that the filing of such notice is mandatory. . . .

The prescribed Form 704 indicates that an approximation must be given with respect to the various types of property in the estate, but it is understood in many cases that this requirement is ignored and a lump sum is inserted.

It is obvious that ad valorem penalties cannot be asserted on the failure to file this notice because there is no tax by which the penalty could be measured. However, [§7269] apparently imposes a mandatory penalty of not exceeding $500 on the person failing to comply with the filing of such returns, together with the cost of the suit to be recovered in a civil action in the name of the United States. Nevertheless it appears to be the general practice that such penalties are not asserted except in a case of a refusal to file such notice after demand. Such penalty necessarily would be imposed directly upon the executor and would not be a charge against the estate. . . .

II. Federal Estate Tax Return

The Federal Estate Tax Return (Form 706) must be filed in duplicate within fifteen months from the date of death. [For extensions of time, see Regs. §20.-6081-1.] Aside from the usual penalties for failing to file an estate tax return on time, the regulations specifically provide that the failure to file the timely return loses to the estate the privilege of using the [alternate] valuation date. [Regs. §20.2032-1(b)(2).]

In preparing the estate tax return one of the most important problems is choosing the appropriate valuation date and sustaining the valuation that is most advantageous to the estate. . . . It is the opinion of many that the failure to select the proper date is justification for surcharging an executor with the loss unless it can be shown that the executor acted with due diligence.

The selection of the [alternate] valuation date has income tax consequences to the estate. On one hand if the value a year after the date of death is selected there may be no income tax but if the value at the date of death is selected, a sale might result in a loss which is an allowable deduction. Of course in many instances this is an impractical hope in that the Revenue Agent will use hindsight and contend that the value at the date of disposition was the value at the date of death. In valuing property, consideration must be given to the immediate possibilities of sale, e.g., the difference in tax rates between the estate tax rate and the income tax rate, especially if any profit on the sale will be taxed as ordinary income. Another frequent problem is the valuation of notes — the balancing of the probability of payment against receiving some ordinary income if payment is received.

An additional difficult problem is raised by the requirement that certain lifetime gifts be declared in the return even though the executor contends that such transfers are not includible in the taxable estate.* . . . In many instances it is believed this requirement is virtually ignored until examination of the return and it is the belief of many that only experienced preparation protects an estate from "overdisclosure" in the preparation of the return. A question to be resolved is the ever present conflict between the executor's duty to the estate and his duty to the Federal Government.

III. Payment of Estate Tax

A frequently misunderstood point is that an extension of time for filing the estate tax return is entirely distinct from an extension of time for the payment of tax. The tax must be paid at the end of fifteen months after the date of death

* Regulations §20.2018-3(c)(7) requires the executor to report (a) all transfers of $1000 or more within the 3-year period preceding death, and (b) all transfers in trust of $5000 or more regardless of date, whether the transfers are regarded as taxable or not. Bona fide sales for full consideration are excepted. — Ed.

unless . . . an extension of time [is granted] on a showing that the payment at the regular time would work an undue hardship upon the estate. [§6161(a)(2).] An illustration of this hardship is the disposition of property at a sacrifice in order to raise the money for the payment of the tax. . . .

The statute provides for an extension of time for payment of any estate tax on a reversionary or remainder interest, belonging to the decedent, for six months after the time such interest vests in possession. However, a bond of double the amount of tax attributable to such interest plus interest at 4 per cent for the estimated duration of the extended period, commencing 18 months after the date of death must be filed. The Commissioner must be advised annually in September of the status of the matter. [§6163(a); Regs. §20.6165-1.]

IV. Preparing and Filing Income Tax Returns

Generally two or more income tax returns are required to be prepared and filed by the executor.

A. Income to Date of Death

The first one is the last return of the deceased, covering the period between the end of the last taxable period of the decedent and the date of death [§6012-(b)(1)].

A further income tax problem is raised by [§6013(a)(3)] which provides for a joint return by the surviving spouse and the executor. Such joint return in most cases will reduce the combined income taxes of the estate and the spouse. However, there is the question of the executor's ascertaining whether the income of the spouse is being correctly reported and whether there might be subsequent developments that would render the joint return injurious to the estate. The Report of the Probate Courts Committee of this Section [Section of Real Property, Probate and Trust Law, A.B.A.] for 1949 suggested the possibility of personal liability to the executor under such circumstances and advises use of an indemnity agreement (a form is provided) and the necessity of collateral. The agreement further provides for the apportionment of refunds, deficiencies and cooperation on procedural steps. Certainly there is substantial peril to the executor if the joint return is for the sole benefit of the surviving spouse.*

In a similar field the executor must consider his assent to a return previously filed. Even though a joint return is filed by a surviving spouse, an executor later appointed may disaffirm within one year after the last day prescribed by law for filing the return of the surviving spouse. The separate return thereafter made by the executor will constitute the return of the deceased spouse for the taxable year. In the absence of specific authority, (some states have special statutes) the present general practice apparently is to judge each case on its merits, e.g., if it is to the advantage of the estate or the risk is not great, the joint return procedure is followed.

B. Income During Probate

. . . An election is given with reference to the deductions described in [§642(g)] between taking such items on the income tax return of the estate or on the estate tax return.† Obviously such deduction should be taken where it will yield the most tax benefit. If such deductions are claimed on the income tax return, it is mandatory that a statement be filed therewith, waiving the right to claim

* See In re Floyd's Estate, supra page 336. — Ed.

† Supra page 1273. — Ed.

the same deduction on the estate tax return. The failure to file such statement loses the income tax deduction even though no estate tax return was required because the gross estate was less than $60,000. The election is an annual one for the expenses of the year concerned.

On the other hand deductions for expenses, interest, taxes and depletion in respect of a decedent allowable under [§691] may be taken on both the income tax return of the estate, if it is otherwise a deductible item by the estate, and as an estate tax deduction, if otherwise allowable on the estate tax return.

C. Executor's Personal Liabilities

In reporting the income of the decedent, it is becoming increasingly obvious that it is the duty of an executor to examine the prior returns of the decedent and to make some reasonable check between the assets in the estate and these returns. A correlation of the two may make it obvious on the usual "net worth" basis that the decedent had been failing to report part or all of the income from his assets. As has been pointed out by one authority:

> If a careful investigation of all the available evidence, a comparison with returns filed and the questioning of all persons in a position to shed any light on the facts leads the executor to feel reasonably sure that false returns were filed by decedent, it would appear that a clear duty exists to disclose the facts through the preparation and filing of amended returns insofar as it may be possible to prepare such returns. A failure to do so might result in a criminal charge against the executor for the concealment of a material fact in dealing with an agency of the United States. A violation of [§§7201-7203] might also be involved. [Stutsman, Tax Responsibilities of an Executor, 1950 So. Calif. Tax Inst. 551, 564.]

There is no way that the executor may terminate his responsibilities for the penalties that might be imposed with respect to false returns.

Section 3466 of the Revised Statutes creates a priority in payment in favor of debts to the United States "whenever the estate of a deceased debtor in the hands of the executors or administrators is insufficient to pay all of the debts due from the deceased." Complementary §3467 provides for the personal liability of the executor if the injunction of §3466 is violated. In the interpretation of these sections of the statutes, the estate tax regulations provide [that an executor who pays any debt or distributes any portion of the estate before the estate tax is paid in full shall be "personally liable, to the extent of the payment or distribution, for so much of the estate tax as remains due and unpaid." Regs. §20.2002-1.]

V. REQUEST FOR EARLY DETERMINATION OF TAXES

In addition to requesting an early determination with respect to income taxes [under §6501(b)], the executor under [§2204] has the right to request the determination of the Federal estate tax within one year from the filing of the return. Thereupon the executor is released from personal liability for any deficiency in estate tax found due after that date.

Many do not realize that such discharge is limited to the *personal liability* of the executor for unpaid Federal estate tax. Such request does not discharge the liability of the estate nor does it release the executor from liability for any other charges asserted under §3466 and §3467. Section [2204] has no applicability to the liability of any person as a transferee of estate assets.

VI. Duty to Obtain Reimbursement for Estate Taxes

Section [2206; supra p. 1254] provides that an executor "shall be entitled" to recoup from the beneficiary of any life insurance included in the gross estate such portion of the total estate tax payable as the proceeds of the policies bear to the sum of the net estate and the statutory exemption allowed in computing such net estate. . . . Section [2207; supra p. 1268] extends a similar authority to recoup proportionately from the object of the power of appointment over which the decedent-donee had a power of appointment. This duty to obtain reimbursement does not extend under either Section to property qualifying for the marital deduction except to the extent that the amount of insurance or property received exceeds the allowable marital deduction. Each section is subject to contrary instructions in the decedent's will.

It is obvious that the expression "shall be entitled" to recoupment is ambiguous. Since this is a matter of state law, some states settle the matter by specific provision in their statutes.* In the absence of an agreement among all parties in interest that the estate itself shall discharge the entire tax burden, in the states having no such statutes it seems that a prudent executor would file suit, if necessary, against any such person to discharge the duty of the executor to conserve the estate. Otherwise there would be grounds for objection by the beneficiaries of the estate with the possibility of surcharging the executor.

VII. Duty to File Gift Tax Return

[Regs. §25.6019-1(b); see §6903] enjoins the executor to file gift tax returns . . . for the decedent. Assuming research reveals no delinquent returns for the past, there arises a problem similar to the one discussed heretofore as to a joint income tax return with the surviving spouse.

The executor [is authorized] to consent to gifts of the surviving spouse and vice versa. [§2513.] If the executor consents, the benefit to the estate apparently is non-existent and the executor must seek adequate protection. If the decedent made the gift, an obvious duty falls on the executor to seek immediately the consent of the surviving spouse.

VIII. Distribution of Income

There is the responsibility for tax planning which may not be such a duty as to incur a surcharge upon the executor, but it is the type of responsibility that is implicit in the proper execution of fiduciary duties. It is becoming increasingly obvious that in substantial estates or where the beneficiaries of the estates already have substantial income, the executor annually ought to assemble the facts and figures that will reveal the probable net income of the estate before the end of the year, and then consult the beneficiaries of the estate so as to coordinate distributions from the estate in a manner that will minimize the income tax liabilities of all. Implicit in such undertaking will be the necessity of deciding as soon as the executor is appointed the question of how soon any testamentary trusts can be set up, the interpretation of any provisions of the will, and whether or not there are sufficient assets to avoid any personal liability to the executor making such distributions.

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* Infra page 1360. — Ed.

The matter has been summarized by Armstrong ("Tax Planning for Distributions," 90 Trusts and Estates 378 (1951)) as follows:

> The executor will engage in a multiphase calculation having the object of estimating or determining the amount of administration expense to be paid in the first year and deduct it for income (as distinguished from estate) tax purposes; the amount of income to be distributed and taxed to heirs and legatees and the amount that will remain for taxation to the estate; the effect of the presence of a testamentary trust (if there is one), particularly a trust where the fiduciary has the discretion either to retain or to distribute income with the result of retaining or shifting the tax burden as between the trust and beneficiaries; the desirability of filing a joint return for the decedent and a surviving spouse (if there is one). The objective is, of course, to get losses and expense deductions into the year and return where they will do the most good, and to spread the income around among the estate, the testamentary trust, the surviving spouse and the heirs or legatees in such a fashion that the respective taxable incomes of all are brought as nearly as possible to a common level.

Generally speaking the exact measure of the liability of the executor for the failure to discharge the duties discussed herein has not been clarified by the courts. "But it is difficult to conceive of a court being sympathetic toward an executor, particularly one who makes such his profession, who failed to avail himself of every opportunity to minimize the tax burden of the estate and therefore of the beneficiaries who receive it." [Stutsman, Tax Responsibilities of an Executor, supra.]

NOTE

1. *Extension of time for payment.* Section 6161(a)(2) (extension of time for payment of estate tax in cases of "undue hardship") has recently been interpreted to permit an extension if property would have to be sold "at a sacrifice price or on a severely depressed market" or if an interest in a family business would have to be sold to "unrelated persons" even if it could be sold at its current fair market value. Regs. §20.6161-1(b). An extension of time under §6161(a)(2) may not exceed 10 years, is subject to payment of interest, and may be conditioned on the posting of a bond under §6165 in an amount equal to double the postponed tax. Similar conditions are applicable to an extension of time under §6163 (tax attributable to reversionary or remainder interest included in gross estate), except that the extension may run until 6 months after the interest falls in, plus an additional 3 years if prompt payment at that time would produce undue hardship.

Section 6166, enacted in 1958, permits the executor to elect to pay the estate tax attributable to an "interest in a closely held business" (as defined) in installments over a 10-year period, if the value of the interest exceeds 35 per cent of the gross estate or 50 per cent of the taxable estate. Unlike an extension under §6161(a)(2), which is discretionary with the government, an extension under §6166 is a matter of right. If the business interest is sold or if there are aggregate withdrawals of 50 per cent or more of its value, however, the extension of time is terminated and the unpaid tax becomes due and payable upon demand.

2. *Estate tax liens.* In addition to the general tax lien of §6321 (the scope of which is described by §§6322-6323), a special lien for estate taxes is created by §6324, valid for ten years against the gross estate. If property is transferred to a bona fide purchaser or mortgagee for full consideration, the lien attaches to the proceeds. Special rules are provided to protect purchasers of securities and, under a 1964 amendment, motor vehicles, and the Internal Revenue Service has authority under §6325 to release the liens (e.g., to facilitate a sale of property) if a bond is posted or if the value of the remaining property is at least double the unpaid tax.

3. *Personal liability of fiduciary.* The executor may become personally liable for an unpaid estate tax by virtue of Title 31, §192, imposing personal liability if a fiduciary pays "any debt" of the estate or trust before satisfying its obligations to the United States. The Regulations construe the term "any debt" as used in this provision to include a beneficiary's distributive share of the estate. Regs. §20.2002-1.

4. *References.* Report of Subcommittee on Post-Mortem Tax Planning, Committee on

Estate and Tax Planning of A.B.A. Section of Real Property, Trust and Probate Law, 101 Trusts & Estates 900 (1962) (with extensive bibliography); Halbach, Post-Mortem Estate Planning, 1963 U. of Ill. L.F. 212; Huffaker, Stutsman, and Angvire, Tax Problems of Fiduciaries (Jt. Comm. on Continuing Legal Education, 1961) 170 et seq.; Plumb and Wright, Federal Tax Liens (ibid.) passim; Wright, Title Examination as Affected by Federal Gift and Estate Tax Liens, 51 Mich. L. Rev. 325 (1953); Alexander, Personal Liability of Executors and Trustees for Federal Income, Estate, and Gift Taxes, 9 Tax L. Rev. 1 (1953); Hewitt, Deferred Payment of Estate Taxes, 1960 So. Calif. Tax Inst. 793.

SCHUSTER v. COMMISSIONER

312 F.2d 311 (9th Cir. 1962)

Before STEPHENS, JERTBERG and KOELSCH, Circuit Judges.

KOELSCH, Circuit Judge.

These are actions combined in this court to review two decisions of the Tax Court sustaining the Commissioner's determination that the petitioners are liable as transferees for unpaid estate taxes, pursuant to [§6324(a)(2) and §6901(a)(1)(A)].*

Upon the death of William P. Baker in 1951, his will was duly admitted to probate in California, the state of his residence, and his widow, Melba Baker (now Schuster), was appointed executrix. On October 7, 1952, Schuster filed an estate tax return to which she attached a copy of a trust agreement, executed between the decedent and the petitioner Bank. This agreement, dated September 12, 1941, designated Baker's daughter, Patricia Baker Englert, as beneficiary, and provided that the trust was to terminate and the property to be distributed to her on June 28, 1955, when she reached 30 years of age. It also contained the provision, which Baker had not invoked, permitting him to revoke the trust during his lifetime. The executrix reported the trust for disclosure purposes only, as she did not deem the corpus to be part of the decedent's estate. The then Commissioner, T. Coleman Andrews, concurred with the executrix but determined certain deficiencies in estate tax, which she paid out of the estate.

Shortly before the trust terminated, the beneficiary's husband advised the Bank that all gift taxes applicable to the trust and all estate taxes had been paid. Thereupon, the Bank distributed all the trust property and closed its file.

Andrews was succeeded as Commissioner by Russell C. Harrington. He decided the trust corpus constituted an asset of the decedent's estate for tax purposes, and that a deficiency accordingly existed. But although the estate was not finally distributed, and had assets in excess of the claimed deficiency, proceedings against it for collection was barred by the three-year statute of limitations provided by [§6501(a)].

However, [§6324(a)(2)] provides that if an estate tax is not paid when due, then the "spouse, transferee, trustee, surviving tenant . . . or beneficiary," among others, who receives or has on the date of decedent's death property "included in the gross estate" is "personally liable" for its payment. And [§6901] provides that the Commissioner might proceed against a "transferee" to collect the tax in the same way he might proceed against the estate. The section also allows a pro-

* Section 6324(a)(2) provides: "If the estate tax . . . is not paid when due, then the spouse, transferee, trustee . . . , surviving tenant, person in possession of the property by reason of the exercise, nonexercise, or release of a power of appointment, or beneficiary, who receives, or has on the date of the decedent's death, property included in the gross estate under sections 2034 to 2042, inclusive, to the extent of the value, at the time of the decedent's death, of such property, shall be personally liable for such tax." Section 6901(a)(1)(A) provides that the liability "at law or in equity, of a transferee of property . . . of a decedent" shall be assessed, paid, and collected in the same manner and subject to the same limitations as the tax itself, except that under §6901(c)(1) the statute of limitations does not expire until 1 year after expiration of the time applicable to the transferor. — ED.

posed assessment against a "transferee . . . within one year after the expiration of the period of limitation for assessment against the executor," or four years after the filing of the return. Finally, the section defines "transferee" as "a person who, under [§6324(a)(2)], is personally liable for any part of the tax."

Acting pursuant to these sections, the Commissioner, on September 6, 1956, mailed deficiency notices to the Bank, as trustee, to Schuster, as surviving tenant, and to Englert, as transferee. Each of them thereupon petitioned the Tax Court to review the Commissioner's determinations.

The Tax Court held that Englert was not liable,[1] but it sustained the Commissioner's determinations of deficiency against Schuster and the Bank, and they have brought the matters here. The Commissioner has not sought a review of the adverse decision in the case against Englert, but he has filed cross-petitions assigning as error the Tax Court's failure to include interest on the deficiencies found due from Schuster and the Bank. The Bank concedes that the trust corpus was properly includable in the gross estate, as required by [§6324(a)(2)], and Schuster makes the same concession regarding the property held by her in joint tenancy with decedent during his lifetime. They also concede that the Commissioner sent the deficiency notices within four years after the filing of the estate tax return, as required by [§6901(c)(1)]. But they raise several issues of law in an effort to secure reversals of the Tax Court's decision. Petitioners' contentions will be considered seriatim.

It is petitioners' position that their substantive liability for the estate tax deficiency depends on state law, and that they are not liable under the law of the appropriate state, California. Their basic premise is that there is no federal law which establishes their substantive liability. They assert that [§6901], under which the Commissioner is permitted to assess and collect deficiencies from transferees, does not establish the transferee's liability, but is merely a procedural statute which enables the Commissioner to proceed against the transferee as he might against the estate. . . . The petitioners point out that a provision similar to [§6901(a)(1)] governs the Commissioner's right to enforce the liability of transferees for the transferor's deficiency in *income* taxes.* In Commissioner v. Stern [supra p. 929], the Supreme Court held that this provision does not impose substantive liability on transferees, but merely refers this question to the law of the appropriate state. . . . The petitioners argue that the rule of the *Stern* decision should be applied in determining a transferee's liability for a deficiency in estate taxes, and thus that their liability depends on the application of state law. In California, the general rule is that a transferee's liability for the debts of the transferor is secondary, not primary. That is, his liability is conditioned on the creditor's remedies against the transferor, and may not be enforced if the transferor has been relieved from his obligation (Lord v. Morris, 18 Cal. 482 (1861)), or if the transferor is able to pay his obligation (Sherman v. S.K.D. Oil Co., 185 Cal. 534, 197 P. 799 (1921)). The Commissioner has conceded that the estate is relieved from liability because of the expiration of the limitations period, and that the estate is sufficiently solvent to pay the deficiency.

We disagree with the petitioners' major premise that there is no federal law

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[1] The Court held that the term "transferee", as used in [§6324(a)(2)], refers only to transferees of transfers made in contemplation of, or taking effect at, the decedent's death. The Court held that the term "beneficiary", as used in the section, refers only to beneficiaries of life insurance proceeds includable in the decedent's gross estate. Since Mrs. Englert was not embraced within the definition of either term, the Court held that she was not liable for the tax. ([Englert v. Commissioner], 32 T.C. 1008 (1959)).

* The transferee liability provisions of the 1939 Code (which was applicable to the taxable year before the court) were consolidated in the 1954 Code, where they appear as subparagraphs (i) and (ii) of §6901(a)(1)(A). — Ed.

which establishes their substantive liability. It is true, as the petitioners argue, that [§6901] is merely a procedural statute which authorizes the enforcement of a liability which is created elsewhere. But it does not follow that this liability is created by the authority of state rather than federal law. To the contrary, [§6324(a)(2)] makes transferees "personally liable" for an estate tax deficiency due from an estate. This statute has consistently been regarded as the source of such a transferee's substantive liability, and the courts have developed a uniform body of federal law defining the nature and effects of this liability. See Sharpe v. Commissioner, 107 F.2d 13 (3d Cir. 1939); cf. Mississippi Valley Trust Co. v. Commissioner, 147 F.2d 186, 187 (8th Cir. 1945); Baur v. Commissioner, 145 F.2d 338 (3d Cir. 1944); Fletcher Trust Co. v. Commissioner, 141 F.2d 36 (7th Cir.), cert. denied 323 U.S. 711 (1944); LaFortune v. Commissioner, 263 F.2d 186, 187 (10th Cir. 1958); Moore v. Commissioner, 146 F.2d 824 (2d Cir. 1945); Equitable Trust Co. v. Commissioner, 13 T.C. 731 (1949).[2] The line of authority which arrives at a different result respecting the transferee's liability for *income* tax deficiencies is inapposite, for there is no statute similar to [§6324(a)(2)] which makes transferees personally liable for the transferor's deficiency in income taxes. As the Court noted in the *Stern* decision, this was the reason that it was compelled to resort to state law to determine the transferee's liability. . . . Thus, the source of a transferee's substantive liability for a deficiency depends on the nature of the deficiency itself. It is true that this concept results in a disparity in the federal law regarding a transferee's liability for income and estate tax deficiencies, but the disparity was established by the authority of Congress, and we are bound to honor and apply it faithfully.

We conclude that the transferee's liability for estate tax deficiencies, under federal law, is essentially a primary, not a secondary, obligation. Section [6324(a)(2)] specifically imposes some limitations on the liability of such a transferee, for it requires that a deficiency be due from the estate, and that his liability therefor is limited to the value of the estate corpus which he received. But no other limitations were imposed, and there is nothing to suggest that others were intended. Therefore, it seems axiomatic that the transferee's liability for an estate tax deficiency is not conditioned on the Commissioner's remedies against the estate, except as the statute provides otherwise, and is in the nature of a direct and primary obligation independent of the obligation of the estate. As the court declared in the *Mississippi Valley Trust* case, in connection with a comparable statute relating to gift tax deficiencies,

> If the donor fails to pay the automatically imposed tax when due, in accordance with the statute, no matter what the reason for his failure, there is an immediate and direct liability on the donee for the legally-owed tax, to the extent of the value of the gift. [147 F.2d 186 at 187-188].

Indeed, the petitioners' argument that their liability is conditioned on the estate's insolvency is difficult to reconcile with the purpose of [§2205], which gives the transferee the right of reimbursement against the undistributed portions of the estate. This right presupposes a solvent estate at the time the transferee seeks reimbursement, and this condition would presumably be the same as when the deficiency was originally assessed against him. See Equitable Trust Co. v. Commissioner, supra. We conclude that the petitioners are not absolved from liability

[2] With the exception of the *Sharpe* case, all cited cases involve liability arising from the gift tax owing by the transferor. The transferee's liability for a gift tax is essentially the same as his liability for an estate tax, and thus the cases are persuasive authority for the problems raised in this litigation.

because of the Commissioner's failure to take timely action against the estate, or the estate's solvency. . . .

The petitioners contend that their liability is limited to the "property of the decedent" which is in their possession, as that phrase is used in [§6901(a)(1)(A)]. Both petitioners contend that the property which gives rise to their liability did not belong to the decedent at his death. The Bank points out that the decedent transferred the trust corpus to the Bank prior to his death. Schuster asserts that in California, the interest of the surviving tenant in joint tenancy property is derived from the original grant, not from the deceased tenant.

We see little merit to the petitioners' argument. It proceeds from the premise that [§6901] defines the nature of their liability under federal law and, as we have previously indicated, this premise is clearly wrong. The petitioners' liability is based on [§6324(a)(2)], which was amended after the enactment of [§6901] to make transferees liable for property "included in the gross estate" of the decedent. The petitioners have conceded that their property was includable in the decedent's gross estate. Significantly, the amendment specifically included "surviving tenants" and "trustees" within the group upon whom liability is imposed. Congress obviously meant to establish a uniform system of liability for such persons, rather than vary their liability in accordance with the anomalies of state law. Accordingly, we conclude that the petitioners' tax liability is not conditioned on the decedent's proprietary interest in the property under state law.

Schuster urges that she is not liable for the estate tax because the joint tenancy property is deductible as an interest passing to the decedent's surviving spouse, and therefore not includable in the net estate. But as we have already indicated, [§6324(a)(2)] makes the transferee taxable on any property which is included in the decedent's "gross estate." There is no indication that Congress intended to limit her liability to property which is part of the decedent's net estate. Schuster argues that because of the deductibility of the property, it should not be considered as part of the *substantive* gross estate. Aside from the fact that this construction ignores the plain language of the statute, it overlooks the fact that Congress specifically included the "spouse" as among the transferees who were subject to liability; it is true that the enactment of this section preceded the enactment of the marital deduction statue in 1948, but the section was re-enacted in substantially identical form as part of the Internal Revenue Code of 1954. It appears that Congress chose to prefer the Commissioner over the surviving spouse when the estate tax was unpaid, a value judgment which we are not at liberty to question. We conclude that the deductibility of the property from the estate does not protect the surviving spouse from the Commissioner's claim.

The petitioners contend that the Commissioner is estopped from asserting liability because of his earlier determination that they were not liable for the tax deficiency.

[General discussion of estoppel omitted.]

We are unaware of any particular detriment sustained by Schuster in reliance on the Commissioner's mistake, for she did not materially change her position in reliance on his earlier determination. But the Bank has been greatly prejudiced because of the Commissioner's mistake. After it was informed that the trust corpus was not includable in the decedent's gross estate, it distributed the corpus to the beneficiary, and thus no longer retains the property which was the subject of the deficiency. Therefore, any liability of the Bank would have to come out of its own pocket, not the corpus of the trust. This would be grossly unfair to the Bank, especially because it never enjoyed the use of the corpus but merely acted in the capacity of a trustee. It is difficult to see what additional action the Bank

might have taken to protect itself from liability, faced with the beneficiary's demand for the corpus and the Commissioner's determination that it was not taxable. It is our conclusion that the Bank's equitable interest is so compelling, and the loss which it would sustain so unwarrantable, as to justify the application of the estoppel doctrine against the Commissioner.

[The court rejected the argument that §§6324(a)(2) and 6901 deprived the petitioners of due process of law, holding that it is not unreasonably harsh to impose liability on a transferee for unpaid estate tax up to the value of estate property in his possession or to extend the statute of limitations as to transferees.]

NOTE

Discharge of executor under §2204. Note that §2204 provides a procedure by which the executor can protect itself against personal liability for an estate tax deficiency. The bank in the *Schuster* case could not proceed under this provision, however, because it was the trustee of an inter vivos trust, not the executor of the estate.

2. *Apportionment of the Estate Tax*

Although Congress could presumably establish a comprehensive system for apportioning the burden of the federal estate tax among some or all of the persons sharing in the gross estate, it has not done so. Consequently, the federal estate tax must ordinarily be paid out of the residuary estate, like administrative expenses, debts, and other charges. See In re Hamlin, 226 N.Y. 407, 124 N.E. 4 (1919), cert. denied, 250 U.S. 672. If the residue is insufficient, specific legacies and other interests will be abated in the same manner as when debts exceed the residue. Contrariwise, inheritance taxes, which are levied on the recipients of the estate, usually come out of the recipients' shares; thus, residuary legatees are burdened only with the inheritance tax pertinent to their own shares.

It has always been possible for the testator to nullify this normal method of charging the estate tax against the residue by providing in his will that it shall be apportioned among all, or some, of the legatees, but such an apportionment clause is often omitted from the will, even when it is reasonably clear that the decedent would not have wanted the residuary legatees to bear the entire burden. This fact led the New York State Commission to Investigate Defects in the Laws of Estate in 1930 to recommend the enactment of a state statute to apportion the burden of the tax:

> The great complaint against the estate tax has been that this burden falls upon the residuary legatees, who are, under most wills, the widow, children, or nearer or more dependent relatives. Cases have arisen where the residue has been greatly depleted by the imposition of the Federal Estate tax. Moreover, the residuary legatee under the present system is compelled not only to pay the tax assessed against the transfers passing by operation of the will, but is also compelled to pay the tax on other transfers to persons not participating in the decedent's estate. Thus, if a gift in contemplation of death has been made, or a transfer under an inter vivos trust becomes effective by reason of the death of the settlor, the tax on all such transfers is imposed upon the residuary legatees. This new law provides for an equitable apportionment of all these transfers by the surrogate in an accounting or other appropriate proceeding on notice to all the parties. Thus the donee of a gift taking effect at death will be compelled to bear his fair share of the tax upon the amount of the property which he derived and which was included in the general estate subjected to taxation. It is believed that this plan will present a fair, just and equitable method of the allocation of the estate tax, both Federal and State [Legis. Doc. No. 69, pp. 197-198 (1930).]

The hardship is accentuated when there is an unexpected fall in the value of the estate's assets, or where the taxable estate is swollen by the inclusion of inter vivos gifts, insurance proceeds, and property subject to powers of appointment. Apportionment of the federal estate tax against the latter two classes of taxable property is required by §2206 (proceeds of life insurance) and §2207 (appointive property). These federal provisions cover only a small portion of the problem, however, and their very existence suggested (until the case that follows was decided) that a comprehensive state plan of appointment might be invalid on the ground that the federal government had pre-empted the field.

RIGGS v. DEL DRAGO

317 U.S. 95 (1942)

MR. JUSTICE MURPHY, delivered the opinion of the Court.

The question for decision is whether §124 of the New York Decedent Estate Law, which provides in effect that, except as otherwise directed by the decedent's will, the burden of any federal death taxes paid by the executor or administrator shall be spread proportionately among the distributees or beneficiaries of the estate, is unconstitutional because in conflict with the federal estate tax law.

Testatrix, a resident of New York, died on October 8, 1937, leaving a will dated March 27, 1934, which, after certain gifts of personal effects and small sums of cash, bequeathed $300,000 outright to respondent Giovanni del Drago and created a trust of $200,000 for the benefit of respondent Marcel del Drago during his life, with remainder over upon his death. The residue of testatrix's estate was left in trust for the benefit of Giovanni during his life, with remainder over upon his death. The will contained no reference to the payment of estate or inheritance taxes.

The executors paid approximately $230,000 on account of the federal estate tax and then asked the Surrogate, in a petition for the settlement of their account, to determine whether that payment should be equitably apportioned among all the persons beneficially interested in the estate pursuant to §124 of the Decedent Estate Law. Giovanni and Marcel del Drago answered, raising objections to the constitutionality of §124. Petitioner, who was appointed special guardian to represent the interests of the infant remaindermen under the residuary trust, urged that the tax be apportioned. The Surrogate overruled the constitutional objections and directed apportionment. The New York Court of Appeals by a divided court reversed, holding §124 repugnant to the federal estate tax law — particularly to [§2205] — and in violation of the supremacy (Art. VI, cl. 2) and the uniformity (Art. I, Sec. 8, cl. 1) clauses of the Constitution. The importance of the question moved us to grant certiorari.

We are of opinion that Congress intended that the federal estate tax should be paid out of the estate as a whole and that the applicable state law as to the devolution of property at death should govern the distribution of the remainder and the ultimate impact of the federal tax; accordingly, §124 is not in conflict with the federal estate tax law. This conclusion is based upon the provisions of the Revenue Act of 1916, 39 Stat. 756, and subsequent acts, their legislative history and their administrative interpretation.

In the Act of 1916 Congress turned from the previous century's inheritance tax upon the receipt of property by survivors (see Knowlton v. Moore, 178 U.S. 41; Scholey v. Rew, 23 Wall. 331) to an estate tax upon the transmission of a statutory "net estate" by a decedent. That act directed payment by the executor in

the first instance, §207, but provided also for payment in the event that he failed to pay, §208. It did not undertake in any manner to specify who was to bear the burden of the tax. Its legislative history indicates clearly that Congress did not contemplate that the Government would be interested in the distribution of the estate after the tax was paid, and that Congress intended that state law should determine the ultimate thrust of the tax.[1] That Congress from 1916 onward has understood local law as governing the distribution of the estate after payment of the tax (with the limited exceptions created by [§§2206 and 2207], to be discussed presently) is confirmed by [§2055(c)], dealing with charitable deductions, which recognizes that estate taxes may be payable in whole or in part out of certain bequests, etc. "by the law of the jurisdiction under which the estate is administered." The administrative interpretation has been in accord, and that has been the understanding of the federal courts, and of some state courts.

In reaching a contrary result, the court below relied primarily upon [§2205]. But that section does not direct how the estate is to be distributed, nor does it determine who shall bear the ultimate burden of the tax. As pointed out before, while the federal statute normally contemplates payment of the tax before the estate is distributed, [§2002], provision is made for collection of the tax if distribution should precede payment. [§7404.] If any distributee is thus called upon to pay the tax [§2205] provides that such person "shall be entitled to reimbursement out of any part of the estate still undistributed or by a just and equitable contribution by the persons whose interest in the estate of the decedent would have been reduced if the tax had been paid before the distribution of the estate." By that section Congress intended to protect a distributee against bearing a greater burden of the tax than he would have sustained had the tax been carved out of the estate prior to distribution; any doubt that this is the proper construction is removed by the concluding clause of the section specifically stating that it is "the purpose and intent of this [chapter] that so far as is practicable and unless otherwise directed by the will of the decedent the tax shall be paid out of the estate before its distribution." Section [2205] does not command that the tax is a nontransferable charge on the residuary estate; to read the phrase "the tax shall be paid out of the estate" as meaning "the tax shall be paid out of the *residuary* estate" is to distort the plain language of the section and to create an obvious fallacy. For in some estates there may be no residue or else one too small to satisfy the tax; resort must then be had to state law to determine whether personalty or realty, or general, demonstrative or special legacies abate first. In short, [§2205], especially when cast in the background of Congressional intent discussed before, simply provides that, if the tax must be collected after distribution, the final impact of the tax shall be the same as though it had first been taken out of the estate before distribution, thus leaving to state law the determination of where that final impact shall be.

1 Congressman Cordell Hull, one of the supporters of the 1916 Act and its reputed draftsman, declared: "Under the general laws of descent the proposed estate tax would be first taken out of the net estate before distribution, and distribution made under the same rule that would otherwise govern it. Where the decedent makes a will he can allow the estate tax to fasten on his net estate in the same manner, or if he objects to this equitable method of imposing it upon the entire net estate before distribution he can insert a residuary clause or other provision in his will, the effect of which would more or less change the incidence of the tax." 53 Cong. Rec. 10657.

Congressman Kitchin, Chairman of the House Ways and Means Committee, stated: "We levy an entirely different system of inheritance tax. We levy the tax on the transfer of the flat or whole net estate. We do not follow the beneficiaries and see how much this one gets and that one gets, and what rate should be levied on lineal and what on collateral relations, but we simply levy on the net estate. This also prevents the Federal Government, through the Treasury Department, going into the courts contesting and construing wills and statutes of distribution." 53 Cong. Rec. app. p. 1942.

Respondents also rely on [§2206], authorizing the executor to collect the proportionate share of the tax from the beneficiary of life insurance includible in the gross estate, and [§2207], authorizing similar action against a person receiving property subject to a power [of appointment], as forbidding further apportionment by force of state law against other distributees. But these sections deal with property which does not pass through the executor's hands and the Congressional direction with regard to such property is wholly compatible with the intent to leave the determination of the burden of the estate tax to state law as to properties actually handled as part of the estate by the executor.

Since §124 of the New York Decedent Estate Law is not in conflict with the federal estate tax statute, it does not contravene the supremacy clause of the Constitution. Nor does the fact that the ultimate incidence of the federal estate tax is governed by state law violate the requirement of geographical uniformity. Cf. Phillips v. Commissioner, 283 U.S. 589, 602.

The judgment is reversed and the cause remanded for further proceedings not inconsistent with this opinion.

Reversed.

NOTE

1. *Federal impact of state apportionment.* Note the reference in Riggs v. Del Drago to a Congressional "intent to leave the determination of the burden of the estate tax to state law as to properties actually handled as part of the estate by the executor." If this implies that the states may not apportion against non-probate property, the implication has been consistently ignored by state statutes and practice. What if the state apportionment formula would impose a heavier — or a lighter — burden on life insurance beneficiaries and recipients of appointive property than is imposed by §2206 and §2207 of the 1954 Code?

Although Riggs v. Del Drago seems to imply that apportionment has no bearing on the *amount* of federal estate tax due, in fact it plays a role in determining the amount, as well as the distribution, of the tax. Thus, if the residue of an estate is left to charity or to the decedent's surviving spouse, the amount of the charitable or marital deduction will be affected by whether the tax is to be paid out of the residue or apportioned among the beneficiaries of the estate. See §2055(c) and §2056(b)(4)(A). For this reason, the federal courts sometimes have to pass on questions of state apportionment law in federal estate tax proceedings. See, for example, Second National Bank v. United States, 222 F. Supp. 446 (D. Conn. 1963) (direction in will against apportionment held to be ineffective, with result that state apportionment statute controls and residuary bequest to surviving spouse is not diminished by federal estate taxes). A proceeding to compel reimbursement under §2205 may also require the federal court to decide troublesome questions of state apportionment law, as in Doetsch v. Doetsch, 312 F.2d 323 (7th Cir. 1963) (conflict of law re apportionment when gross estate includes out-of-state inter vivos trust).

2. *Testamentary clauses negating apportionment.* State apportionment statutes typically apply except where the testator "otherwise directs in his will," and §2206 and §2207 of the Code (relating to life insurance beneficiaries and recipients of property subject to a taxable power of appointment) also permit the decedent to direct in his will that the tax shall not be apportioned. The decedent in In re Mills' Will, 272 App. Div. 229, 70 N.Y.S.2d 746 (1st Dept. 1947), directed that all death taxes "imposed upon my estate or any part thereof, or the transfer thereof or any right of succession thereto" be paid out of the residuary. The court held that this direction was not sufficiently clear to negate the equitable apportionment required by §124 of the New York Decedent Estate Law; the testator, a former Secretary of the Treasury, had created certain inter vivos trusts that were outside the probate estate but included in the taxable estate, and the court held that the reference in his will to death taxes "on my estate" referred only to his probate estate. The court implied that a simple direction that "all inheritance, estate, transfer and succession taxes be paid out of my residuary estate" would be sufficient to negate §124 of the

New York law. In McLaughlin v. Green, 136 Conn. 138, 69 A.2d 289 (1949), however, a direction of this character was held insufficient under a similar Connecticut law, and the court suggested that a more elaborate formula be employed. There is a large volume of litigation on the effectiveness of testamentary clauses negating apportionment, often stemming from a post-mortem realization that payment of death taxes from the residue will diminish the share going to the surviving spouse and thus increase the federal estate tax by reducing the marital deduction. As the foregoing cases indicate, testamentary clauses are sometimes disregarded by the courts because the status of inter vivos transfers is left ambiguous by the clause. See also In re Halsted's Estate, 174 Misc. 292, 20 N.Y.S.2d 627, aff'd without opinion, 26 N.Y.S.2d 310 (App. Div. 1st Dept. 1941), where a clause directing payment of death taxes out of the residue of an estate was held to be nugatory because there was no residue.

3. *Non-statutory apportionment.* Even without statutory authority, state courts have been increasingly willing to apply a doctrine of equitable apportionment to relieve the residuary legatees of the tax caused by inter vivos transfers and other non-probate property. Regents of the University System v. Trust Co. of Ga., 194 Ga. 255, 21 S.E.2d 691 (1942); Carpenter v. Carpenter, 267 S.W.2d 632 (Mo. 1954). See also Dodd v. United States, 223 F. Supp. 785 (D.N.J. 1963), holding that the New Jersey rule requiring the federal estate tax to be paid from the residue in the absence of a contrary direction by the testator permitted apportionment *within the residue;* the residue was divided between the testator's children and his surviving spouse, and the court held that the tax was payable in full out of the share going to the children because the wife's share qualified for the marital deduction and did not contribute to the tax liability. Note how this result affected both the amount and the distribution of the tax burden. Would it have been more equitable to charge the children's share of the residue with the tax attributable to them, and to divide the balance of the tax between the children and the widow?

4. *References.* Powell, Ultimate Liability for Federal Estate Taxes, 1958 Wash. U.L.Q. 327; Lauritzen, Apportionment of Federal Estate Taxes, 1 Tax Couns. Q. 55 (1957); Fleming, Apportionment of Federal Estate Taxes, 43 Ill. L. Rev. 153 (1948); Note, Statutory Apportionment of Federal Estate Taxes, 62 Harv. L. Rev. 1022 (1949); Sutter, Apportionment of the Federal Estate Tax in the Absence of Statute or an Expression of Intention, 51 Mich. L. Rev. 53 (1952); Scoles, Apportionment of Federal Estate Taxes and Conflict of Laws, 55 Colum. L. Rev. 261 (1955); Uniform Estate Tax Apportionment Act, 9A U.L.A.; Scoles and Stephens, The Proposed Uniform Estate Tax Apportionment Act, 43 Minn. L. Rev. 907 (1959).

SECTION B. THE GIFT TAX

A gift tax return must be filed by any person who makes a gift (or several gifts in one calendar year) to any one donee of a value of more than $3000, or a gift of a future interest regardless of its value. §6019(a). The return must be filed even if the gift is not taxable because the donor has not exhausted his $30,000 exemption. Donees were formerly required to file information returns, but this requirement was eliminated in 1959.

In Baur v. Commissioner, 145 F.2d 338 (3d Cir. 1944), it was held that a donee of a nontaxable gift (e.g., a gift of less than $3000) is liable for an unpaid tax on a gift made by the same donor to another donee in the same calendar year, by virtue of §6324(b), and that this liability could be enforced even though the donor was not insolvent at the time of the gifts and was not made insolvent thereby. See also Moore v. Commissioner, 146 F.2d 445 (2d Cir. 1945).

If the donee's interest in the transferred property is defeasible (for example, by the donee's predeceasing the donor or by the exercise of a power to alter or amend vested in a third party), may transferee liability be imposed upon the donee? See Estate of Sanford v. Commissioner, supra page 1150.

See Clark, Federal Tax Liens and Their Enforcement, 33 Va. L. Rev. 13 (1947); Peters and Maxey, The Gift Tax Lien and the Examination of Abstracts, 5 Miami L.Q. 64 (1958).

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